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In the Supreme Court
OF THE
United States

OCTOBER TERM, 1970

No. 467

IRVING GORDON and MARGARET GORDON,
Petitioners,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI
to the United States Court of Appeals
for the Second Circuit

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COMMISSIONER OF INTERNAL REVENUE,
Respondent.

PETITION FOR A WRIT OF CERTIORARI to the United States Court of Appeals for the Second Circuit

Irving Gordon and Margaret Gordon pray that a writ of certiorari issue to review a judgment of the United States Court of Appeals for the Second Circuit, which affirmed a decision of the Tax Court of the United States that petitioners owed additional Federal income tax for 1961.

OPINIONS BELOW

The opinion of the Tax Court (S.A.[1] 81-109), printed in Appendix B, infra, pages 7A to 35A, is reported at 51 T.C. 1032. The opinion of the Court of Appeals for the Second Circuit, printed in Appendix C, infra, pages 37A to 54A, is officially reported at 424 F.2d 378. Both decisions below were rendered on remand of the case from a decision of this Court on a separate aspect (*Commissioner v. Gordon* (1968) 391 U.S. 83). The opinions of this Court on the prior appeal (S.A. 63-79) is printed in Appendix D, infra, pages 55A to 71A. It reversed decisions of the Tax Court (45 T.C. 71) and of the Second Circuit (382 F.2d 499; S.A. 3) in favor of the taxpayers, and affirmed a decision of the Court of Appeals for the Ninth Circuit (382 F.2d 485; S.A. 36) in a companion case (*Oscar E. Baan and Evelyn K. Baan v. Commissioner of Internal Revenue*) that was consolidated with this one for trial.

JURISDICTION

The judgment of the Court of Appeals for the Second Circuit was entered on March 16, 1970 (Appendix E, infra, page 73A). Petitioners' timely petition for rehearing was denied on May 1, 1970 (Appendix F, infra, pages

[1] The record on appeal is printed in two volumes. The first, entitled "Record Appendix" (R.A.), consists of the record used in a prior appeal of this case to the Second Circuit (Docket No. 30572), and includes a stipulation of facts, exhibits, and the Tax Court trial transcript. The second volume, designated "Supplementary Appendix" (S.A.), includes pertinent opinions from the prior appeal.

74A and 75A). The jurisdiction of this Court is invoked under section 1254(1) of Title 28 of the United States Code, as provided by section 7482(a) of the Internal Revenue Code of 1954 ("the Code") (26 USC § 7482(a) (1964 ed.)).

QUESTIONS PRESENTED

Taxpayers,[2] common shareholders of The Pacific Telephone and Telegraph Company ("Pacific"), received common stock of Pacific Northwest Bell Telephone Company ("Northwest"), in the exercise of rights issued to them by Pacific under its plan of reorganization.

1. Was the receipt of the Northwest stock by taxpayers under the Pacific reorganization, which was both an (F) and a (D) type reorganization (§§ 368(a)(1)(F) and 368(a)(F)(D) of the Internal Revenue Code of 1954), precluded from tax-free treatment under the provisions applicable to (F) type reorganizations because of alleged failure to satisfy the limitations expressly applicable only to (D) type reorganizations?

2. Were the Northwest rights taxable to taxpayers at the time the rights were issued, as the court below held, or is the applicable rule that of *Palmer v. Commissioner* (1937) 302 U.S. 63, that the mere issuance of rights is not taxable?

3. Were the Northwest rights stock or securities of Pacific within the tax-free reorganization provisions of the Code?

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[2] Petitioners Irving and Margaret Gordon, husband and wife, filed a joint Federal income tax return for 1961, and will be referred to herein as "taxpayers".

4. Was the distribution of the Northwest stock "attributable" to Pacific's ceasing to conduct the businesses transferred to Northwest, within the meaning of section 346(b) of the Code, defining one type of partial liquidation?

STATUTES INVOLVED

The case directly concerns the interpretation of sections 354 and 368, or in the alternative, section 346 of the Internal Revenue Code of 1954 (26 USC 354, 368 and 346 (1964 ed.); 68A Stat. 142, 120, 110),[3] pertinent portions of which are set out in Appendix A, infra, pages 1A to 6A.

STATEMENT OF THE CASE

This case involves the correctness of the Commissioner's determination of a deficiency of $895.10 in the Federal income tax liability of taxpayers, residents of New York City, for their taxable year 1961. The Commissioner determined that taxpayers received dividend income which they did not report on their return, from the exercise of stock rights issued to them by Pacific. The facts, as stated in the opinion of the Court of Appeals (Appx. C., infra, pp. 37A to 40A), are as follows[4]:

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[3] References hereinafter to sections are to sections of the Internal Revenue Code of 1954 (26 USC (1964)), unless otherwise indicated.

[4] Where additional details, not included in the opinion of the Court of Appeals, are reflected in the following statement of facts, appropriate reference is made to the Record Appendix volume of the record on appeal.

The taxpayers, husband and wife, were minority shareholders in Pacific, 89 per cent of the stock of which was owned by American Telephone and Telegraph Company ("American"). Pacific, a California corporation, did business not only in that state, but also in Oregon, Washington, and a part of Idaho. Pacific had over 38,000 minority shareholders (R.A. 31).

In 1961, the management of Pacific decided to simplify its administration by dividing Pacific into two corporations, each of which would be owned directly by Pacific's contemporary shareholders. Pacific would transfer to a new company all its operations outside California. Considerations of state law led the management to decide against distributing stock in the new corporation pro rata to the shareholders, whether or not in redemption of Pacific shares which they held.[5] Instead, Pacific decided to create a new subsidiary, called Pacific Northwest Bell Telephone Company, ("Northwest"), a Washington corporation. In return for receiving Pacific's assets in Washington, Oregon and Idaho, Northwest issued all its stock to Pacific and also assumed a proportionate share of Pacific's long-term debt by issuing a demand promissory note to Pacific for $200,000,000. This note reflected, in Northwest's capital structure, the portion of Pacific's long-term debt carried against the assets transferred to Northwest (R.A. 45-46).

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[5]Pacific did not have enough earned surplus to cover a pro rata distribution of Northwest stock, which would have been treated under the California corporation law as a mere dividend. California law also required Pacific to redeem all its voting preferred before redeeming any of the common stock in return for Northwest's stock, and the corporation did not consider this feasible (R.A. 177-178).

This plan of reorganization was adopted in 1961 by the shareholders. The plan required Pacific to offer its Northwest stock to the Pacific shareholders in two or more offerings. The first of these, to involve more than half the Northwest shares, was to take place shortly after the creation of Northwest. The timing of later offerings would depend on Pacific's need for capital, for the Northwest stock would be offered to the shareholders for cash in connection with the stock rights previously issued to them. The cash would cover Pacific's cost for the Northwest shares transferred to the shareholders, and thus would obviate Pacific's earned surplus problem (R.A. 177-178).

The transfer to Northwest of Pacific's northern division, created the preceding year, took place on June 30, 1961, at which time Pacific ceased to do business in the states of Oregon, Washington and Idaho, and its franchises there were assumed by Northwest (R.A. 34-35, 43-45). On September 29, 1961, Pacific issued to its shareholders rights to acquire about 57 per cent of Northwest stock, which rights were to remain valid for three weeks. Six rights plus $16 had to be offered for each share of Northwest. The remaining 43 per cent of the Northwest stock was offered in 1963, at a rate of eight rights plus $16 per each Northwest share. In these two offerings, American exercised all its rights and the owners of half of the remaining 11 per cent of Pacific shares also exercised their rights. The remaining rights—about 5 per cent of the total—were exercised either by American in lieu of allowing them to lapse, or by persons to whom they had been publicly traded by Pacific's minority shareholders (R.A. 54).

The present tax dispute grows out of the 1961 offering. Taxpayers, who filed a joint return for that year, exercised their rights to acquire 256 shares of Northwest, worth $6,656, or $26 per share on the date of exercise. In addition to surrendering their stock rights, they paid the required $16 per share for each of the 256 shares, a total of $4,096. The Commissioner sought to tax as a dividend the difference between the cash amount paid and the value, at the time of exercise of the rights, of the Northwest stock received. Taxpayers filed a petition in United States Tax Court pursuant to section 6213 of the Code, seeking redetermination of the Commissioner's deficiency. There, taxpayers contended that the receipt of the Northwest stock was tax-free under sections 355 or 354 of the Code, or alternatively, that the amount treated by the Commissioner as a dividend should instead be taxed as a capital gain from partial liquidation under section 346. The Tax Court agreed with the taxpayers that, pursuant to section 355, the so-called "spin-off" provisions, a gain need not be recognized, and therefore that court did not decide taxpayers' claims under section 354 or 346. The decision of the Tax Court was affirmed by the Second Circuit ((2 Cir. 1967) 382 F.2d 499). The Supreme Court reversed, however ((1968) 391 U.S. 83), holding that the requisite control of Northwest had not passed to Pacific shareholders in 1961, and the case was remanded to the Tax Court for it to consider taxpayers' other claims. On remand, the Tax Court then held ((1969), 51 T.C. 1032), that neither section 354 nor section 346 is applicable to the situation at bar, and it accorded the taxpayers no relief (Appx. B, infra, p. 13A).

Taxpayers then appealed to the Second Circuit, which affirmed the Tax Court (Appx. C, infra, p. 40A).

In the companion *Oscar E. Baan* case which was decided by the Tax Court on remand at the same time as this one, an appeal has been taken to the Court of Appeals for the Ninth Circuit (Docket No. 24621). Briefs have been filed by both parties in that case, but oral argument has not yet been scheduled.

REASONS FOR GRANTING THE WRIT

I. THE DECISION OF THE COURT BELOW THAT THE RECEIPT OF THE NORTHWEST STOCK WAS NOT TAX-FREE UNDER SECTION 354 IS SQUARELY IN CONFLICT WITH RECENT DECISIONS OF THE NINTH CIRCUIT AND THE WELL-SETTLED LAW ON "REORGANIZATIONS" WHICH SATISFY MORE THAN ONE OF THE DEFINITIONS OF THAT TERM IN SECTION 368.

On remand of this case from this Court, under its decision in *Commissioner v. Gordon* (1968) 391 U.S. 83, taxpayers' principal contention was that the Northwest stock was received tax-free under the provisions of section 354(a). That section provides that no gain or loss is recognized on the receipt solely of stock pursuant to a plan of reorganization in exchange for stock or securities of another corporation a party to the reorganization. The court below assumed that the Northwest stock was received by taxpayers in an exchange,[6] but it held that

[6] "We find it unnecessary to pass upon the Tax Court's determination that no 'exchange' took place within the meaning of Section 354. We recognize that taxpayers' exercise of the stock rights replaced certain legal interests with other legal interests" (Appx. C, infra, p. 45A).

the stock rights surrendered by taxpayers did not constitute stock of Pacific and that it was unnecessary to decide whether they constituted securities of Pacific. It seemingly agreed with the taxpayers' contention that there was an (F) type reorganization as defined in section 368(a)(1)(F) (Appx. C, infra, pp. 46A-47A).[7] The court held, however, that even if the transaction qualified as an (F) reorganization, the provisions of section 354(b) relating to (D) type reorganizations precluded tax-free treatment of the exchange. The holding of the court below in this regard is in direct conflict with recent decisions by the Ninth Circuit and with the settled law on the tax effects of transactions satisfying more than one definition of a tax-free reorganization under section 368.

A. The ruling of the court below is in direct conflict with the settled law that the tax-free reorganization definitions in section 368 have independent operative tax effect.

The court below assumed that transfer of the assets to Northwest and the distribution of the Northwest stock to the Pacific shareholders was a reorganization within the provisions of section 368(a)(1)(F).[7] In this respect, the court's assumption was correct and in accordance with the holdings of the Fifth and Ninth Circuit Courts of Appeal (*Davant v. C.I.R.* (5 Cir. 1966) 366 F.2d 874; *Estate of Stauffer v. C.I.R.* (9 Cir. 1968) 403 F.2d 611; *Associated Machine v. C.I.R.* (9 Cir. 1968) 403 F.2d 622).

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[7] "These requirements seem to bar the present transaction from the haven of Section 354 even if the transaction can be found to qualify * * * under Section 368(a)(1)(F)" (Appx. C, infra p. 49A; see pp. 46A-47A).

The court below also held that the transaction was of the type described in the definition of a (D) reorganization (section 368(a)(1)(D)). Nonetheless, it refused to give independent operative tax effect to the reorganization as an (F) type reorganization. The court held that the limitations of section 354(b), which in express terms apply only to (D) reorganizations, operated equally as limitations on a reorganization which qualified as an (F) reorganization.[8] This decision of the court below is in direct conflict with the long-standing and well-settled rule that each type of reorganization must be given independent operative tax effect, even though the transaction may qualify as another type of reorganization.

This question first arose in *Helvering v. Minnesota Tea Co.* (1935) 296 U.S. 378. That case involved the question of whether the transfer of assets by one corporation to another was a tax-free reorganization under the Revenue Act of 1928. The Commissioner contended that there were two definitions of a tax-free reorganization by transfer of assets: (1) Clause B of section 112 of that Act, which required that the transferor obtain control of the transferee; and (2) Clause A, which involved a transfer of assets in a merger or consolidation. The Commissioner contended that the merger or consolidation provisions of Clause A must be limited by the provisions under

[8]Section 354(b) provides that an exchange in a "(D)" type of reorganization will not be tax-free under section 354(a) unless the corporation to which assets are transferred acquires substantially all of the assets of the transferor, and all of the stock and securities received by the transferor are distributed in pursuance of the plan of reorganization. Taxpayers do not contend here that the limitations of section 354(b) are satisfied. Taxpayers' contention is that those limitations are inapplicable to (F) reorganizations.

Clause B in order to prevent overlapping and to make effective the condition in Clause B of transferor control. The Supreme Court rejected this contention:

> "We find nothing in the history or words employed which indicates an intention to modify the evident meaning of (A) by what appears in (B). Both can have effect, and if one does somewhat overlap the other the taxpayer should not be denied, for that reason, what one paragraph clearly grants him" (296 U.S. 384).

The rule has been consistently followed ever since; in the case of transactions which may satisfy one or more of the definitions of tax-free reorganization, the conditions and limitations applicable to each are separately considered as expressly provided for each type of reorganization. This is clearly illustrated by the decision of this Court in *Helvering v. Southwest Consolidated Corp.* (1942) 315 U.S. 194. In that case, the Court considered whether the acquisition of all the assets of a predecessor corporation, through a bondholder's foreclosure proceeding, resulted in a reorganization under section 112 of the Revenue Act of 1934. This section, like section 368 of the 1954 Code, defined separate types of reorganization. There was no contention in the *Southwest* case that the transaction was an (A) type of reorganization. The Court considered whether the transaction came under any one of the other definitions of tax-free reorganizations. It found that the transaction there considered did not qualify either as a (B), (C), (D), or (E) type of reorganization. It considered each type of reorganization separately in the light of the conditions and limitations applicable to each separately.

The court below failed to apply this well-settled and fundamental principle in the application of the definitions of tax-free reorganizations. Instead of giving an (F) reorganization the tax-free effect usually accorded such reorganizations, it grafted onto the (F) reorganization the limitations expressly made applicable by section 354(b) only to reorganizations which are of the (D) type.

The overlap between various types of reorganizations has been recognized since at least 1935 when the *Minnesota Tea* case was decided. This has been so well understood that the Commissioner has stated: "Often a reorganization under section 368(a)(1)(F) of the Code will meet the requirements of subparagraphs (A), (C), or (D) of section 368(a)(1)" (Rev.Rul. 57-276, C.B. 1957-1, 126, 127). Congress took cognizance of this overlapping by providing that in the case of transactions which are both (C) and (D) types of reorganizations, the (D) definition will prevail (section 368(a)(2)(A)). Thus, (C) and (D) types of reorganization are expressly made tax-free under section 354(a) only if the transaction meets the limitations prescribed in section 354(b).[2]

Section 354(b) was first enacted in the Internal Revenue Code of 1954. Prior to 1954, beyond question, exchanges of stock or securities in an (F) reorganization were tax-free under the predecessor provisions of section 354. Equally clearly, section 354(a) continues to treat as tax-free those exchanges of stock or securities under reorganizations solely of the (F) type. The court below, however, has held that an exchange under a reor-

[2]There has never been any question that the transaction at bar was *not* a (C) type reorganization.

ganization which is both an (F) reorganization and a (D) reorganization is not tax-free under section 354(a) unless it satisfies the limitations of section 354(b).

Neither the language of section 354(b) nor that of section 368(a)(2)(A) suggests that where there is present an overlap between (F) and (D) types of reorganizations, there should be any departure from the well established rule that independent, operative tax-free effect should be given to the (F) type of reorganization.

The court's ruling, moreover, renders meaningless the requirement in section 368(a)(2)(A) that the (D) definition shall prevail in transactions which are both (C) and (D) type reorganizations. The court's decision means that the (D) definition prevails in any transaction which qualifies both as a (D) reorganization and also as one or more of the other types of reorganization. If the court is correct in this interpretation, it would have been wholly unnecessary for Congress to provide for (C) type reorganizations a specific exception to the well-established rule that the reorganization definitions operate independently of each other.

Not only is there an absence of statutory language which would preclude the application of section 354(a) to an (F) type of reorganization, but giving effect to the established rule that section 354(a) applies independently to each type of reorganization (except (C)) is in complete harmony with the intent of Congress in revising the reorganization provisions of the 1954 Code. The controlling Congressional intent is that stated in the House Committee Report on the Revenue Code of 1954 as follows:

"Your committee's policy is implemented by allowing the distribution, or exchange, of equity interests in a corporation to the greatest extent possible. *As long as a shareholder's interest remains in corporate solution, there is no appropriate occasion for the imposition of a tax.* Accordingly, the general rule is that no tax is imposed upon the distribution of stock rights and stock dividends or upon exchanges of stock pursuant to readjustments of the corporate structure without regard to whether or not a particular shareholder's proportionate interest in the continuing business has varied. In addition, stock of a subsidiary if distributed will be subject to the same rules although its subsequent disposition may give rise to ordinary income in accordance with the rules later described" (H.Rept. 1337, 83rd Cong., 2d Sess. (1954) p. 35, emphasis supplied).

There is no dispute that the transaction here was motivated by valid business reasons designed to promote improved corporate administration. The transaction had no potential for use in distributing earnings and profits or as a dividend mechanism. Through their receipt of the Northwest stock, the taxpayers did not receive any of the assets of Pacific or Northwest. The business and assets of Pacific prior to the reorganization remained intact in both Pacific and Northwest thereafter. Taxpayers' equity remained in corporate solution. The adjustment of the interests of the taxpayers as shareholders of Pacific was a mere change in form and not a change of substance. Giving effect to the well-established rule that the receipt of the Northwest stock by taxpayers was tax-free under an (F) reorganization fulfills the overriding congressional intent.

B. The ruling of the court below is in conflict with recent decisions of the Ninth Circuit on (F) reorganizations.

In two recent decisions, the Court of Appeals for the Ninth Circuit considered the allowance of carry-back losses in connection with (F) reorganizations. In *Estate of Stauffer v. C.I.R.* (9 Cir. 1968) 403 F.2d 611 and *Associated Machine v. C.I.R.* (9 Cir. 1968) 403 F.2d 622, the issue presented was whether operating losses, sustained by the surviving corporation after a statutory merger, could be carried back to offset profits of the constituent merged corporations which arose prior to the merger. Under express provisions of section 381(b) of the Code, such losses could be carried back if the transaction qualified as an (F) reorganization; carry-back losses occurring after other types of reorganizations, such as an (A) reorganization, could not be carried back.

There was no dispute that the statutory mergers involved in these cases were (A) type reorganizations and hence, tax-free transactions. The court found that, because the transactions were also (F) reorganizations, the loss carry-backs could be allowed under section 381(b), even though they were (A) reorganizations as well, for which carry-backs were not allowable. The Ninth Circuit summarized its conclusion in *Stauffer* as follows:

> "An 'F' reorganization is just that, and tax consequences flow from that determination, not vice versa" (403 F.2d 619).

The decision of the Second Circuit in this case is directly contrary to these decisions of the Ninth Circuit. A limitation which is expressly applicable to (D) type transactions was found by the court below to apply to an

(F) type reorganization merely because the transaction might have qualified also as a (D) type reorganization. This holding is contrary to the well-established rule, as exemplified in the *Stauffer* and *Associated Machine* cases, of giving independent operative effect to each type of reorganization.

II. THE COURT BELOW ERRONEOUSLY ASSUMED, CONTRARY TO THE LONG-STANDING DECISION OF THIS COURT IN THE PALMER CASE, THAT THE PACIFIC NORTHWEST RIGHTS WERE TAXABLE WHEN RECEIVED.

A. Without discussion, the court below, contrary to its own prior decision, and the decisions of all the other courts below, treated the rights as taxable when received.

Ever since the decision in *Palmer v. Commissioner* (1937) 302 U.S. 63, the universal understanding has been that "[t]he mere issue of rights to subscribe and their receipt by stockholders is not a dividend" (302 U.S. 71). Correspondingly, the receipt of stock rights which are allowed to lapse has not been considered to result in any income or loss. The Commissioner determined the deficiency in this proceeding in keeping with these principles. However, when this case was earlier before this Court, the Commissioner contended that the *Palmer* rule was no longer valid under the 1954 Code and that the taxpayers received taxable income when their stock rights were issued. This Court did not resolve this question. When it remanded, it simply noted that the application of the *Palmer* rule under the 1954 Code had not been authoritatively settled (Appx. D, infra, p. 63A).

The court below did not purport to determine whether the rule in the *Palmer* case was still valid, but it neces-

sarily decided the case contrary to the *Palmer* rule when it held that it was unnecessary to decide whether the stock rights were securities because in that event the stock rights were taxable when received. It said:

> "It is of no benefit to taxpayers to obtain tax-free treatment of the exercise of their stock rights if the initial distribution to them of these rights is taxable to the extent of the value of the rights when distributed" (Appx. C, infra, pp. 41A-42A).

In refusing to follow and apply the long-standing rule of this Court in *Palmer*, the Second Circuit ruled contrary to all three lower courts on the first appeal in this case. All three courts below, in this and the companion *Baan* case, held that under the rule of *Palmer* the relevant event in determining the taxability of stock rights was their exercise and not their issuance.[10] The question whether stock rights are taxable when received is of far-reaching importance in the administration of the tax laws. The ruling by the court below, in assuming without discussion that the well-understood rule of the *Palmer* case

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[10]The Tax Court said:

> "However, *Palmer v. Commissioner*, 302 U.S. 63, makes it clear that issuance of the rights, even though they may be valuable, may not be considered as a distribution of corporate earnings and profits. If any income is to be charged to petitioners it must be regarded as stemming from the exercise of the rights, by obtaining the Northwest stock for a consideration less than its fair market value" (45 T.C. 91).

The Second Circuit substantially agreed with this view:

> "Normally, the distribution of a stock right has no tax consequences because there is no distribution of corporate property until the right is exercised" (382 F.2d 505).

While taking a different view of the application of section 355, there at issue, the Ninth Circuit nevertheless agreed with the Tax Court that under *Palmer*, " * * * the mere issue of rights to subscribe and their receipt by shareholders is not a dividend" (382 F.2d 493).

no longer applies, is too important a judicial determination to leave unchallenged. To permit this basic misapplication of the *Palmer* rule to remain undisturbed would create serious confusion in an important area of the administration of the tax laws. Review by this Court is urgently required to resolve this point.

B. The court below erroneously held that the Pacific Northwest rights received were not stock or securities of Pacific.

When the plan of reorganization was adopted, taxpayers as shareholders of Pacific had an equity in several telephone communications businesses, one located in California, and the others in the three northwest states. The plan of reorganization was designed to provide separate corporate control of the businesses in the northwest states, with the same ownership in the Pacific shareholders (Appx. C, infra, p. 37A). These shareholders could not be deprived of their right to continue to participate in the Northwest business. Apart from their pre-emptive rights, they had the right inherent in their Pacific common stock ownership to continue participation in the Northwest business. Because of obstacles under state law, stock of the Washington corporation—through which the separate control of the Northwest business was to be exercised—could not be distributed directly to the Pacific shareholders in exchange for a portion of their Pacific stock interest, with or without the surrender of a portion of their Pacific stock certificates (Appx. C, infra, pp. 37A-38A). To meet the requirements of state law, this phase of the reorganization was effected by a transaction which was part sale and part exchange. The transfer of each share of Northwest stock

reflected in part a purchase for $16 a share, and in part an exchange for a portion of each shareholder's equity in Pacific. The $16 a share paid represented only about 60 per cent of the fair value of each share of Northwest stock. The remaining 40 per cent represented his proportionate interest in the Northwest assets which was held through ownership of Pacific stock, and which was relinquished by any shareholder who allowed his rights to lapse.

The aggregate value of the stock rights was approximately $300 million. The Commissioner has strenuously contended that these rights constituted valuable property in the hands of Pacific shareholders. The taxpayers agree. However, this property did not result from any transfer of corporate assets by Pacific to the shareholders, for all of the corporate assets remained intact in Pacific and in Northwest, both before and after the rights were exercised. The stock rights and the Northwest stock both simply reflected the equity interest of the Pacific shareholders in the corporate assets which remained in Northwest and were never transferred to the Pacific shareholders. The value imparted to the stock rights was therefore not derived from any reduction of corporate assets in the hands of either Pacific or Northwest. Rather, this value came out of the value of their stock equity in Pacific. To the extent that a value was imparted to these rights through Pacific's corporate action in issuing these rights, there was a corresponding diminution in the equity attaching to the Pacific shares retained by the Pacific shareholders. The stock rights, therefore, evidenced part of the equity of the Pacific shareholders in-

the portion of the business of Pacific which was transferred to and remained in Northwest.

The term "stock," like its companion "securities," has never been defined in the income tax provisions.[11] The decided cases, however, clearly establish that the term "stock" means equity ownership in a corporation and need not be evidenced by a stock certificate. In the leading case of *Helvering v. Alabama Asphaltic Limestone Co.* (1942) 315 U.S. 179, the claim of a general creditor in the case of an insolvent corporation was stock for purposes of the reorganization provisions.

The Second Circuit misconstrued the contentions of taxpayers when it said that the taxpayers were in essence contending that "any executory promise of a corporation to convey its assets to another party" is thereby "stock." (Appx. C, infra, p. 42A). The stock rights were issued by Pacific to its common shareholders *to preserve their equity* in the assets in the northwest states which were transferred to Northwest as part of a corporate reorganization. The rights were issued to the Pacific shareholders in recognition of their equity in Northwest held through their Pacific stock. The decision of the lower court is in substance in conflict with the decisions of the courts in *Carlberg v. United States* (8 Cir. 1960) 281 F.2d 507 and *James C. Hamrick* (1964) 43 T.C. 21.

At the very least, the stock rights here were "securities" of Pacific, as held in *E. P. Raymond* (1938) 37 B.T.A. 423 (see Bittker and Eustace, Federal Income Taxation of Corporations and Shareholders, 2d ed., 1966, p. 580, n. 140). They were listed on two stock

[11] S.Rept. 1622, 83rd Cong., 2d Sess. (1954), p. 42.

exchanges, were negotiable, and had all the characteristics of securities in common parlance.

III. THE COURT BELOW ERRONEOUSLY HELD IN THIS CASE OF FIRST IMPRESSION THAT A DISTRIBUTION OF PROCEEDS IS NOT ATTRIBUTABLE TO THE CESSATION OF A BUSINESS, AND IS NOT TO BE TREATED AS A PARTIAL LIQUIDATION UNDER SECTION 346(b), UNLESS THE ENTIRE PROCEEDS ARE DISTRIBUTED.

When Congress adopted the 1954 Code, consideration was given to providing some objective statutory standards for differentiating between partial liquidations entitled to capital gain or loss treatment and those distributions from earnings and profits resulting in ordinary income.[12] Section 346(b), based on the Senate version of this provision, employed as the hallmark of a partial liquidation the termination by a corporation of a business which it had actively conducted for at least a five-year period. Section 346(b) contemplated two possible sources of a partial liquidating distribution which might arise from the termination of such a business: (1) a distribution of the proceeds from the sale or disposition of the assets of the business, or (2) a distribution of the assets of the business directly to the shareholders. In the latter case, the termination of the business results from distribution of the assets, and the distribution *consists* of such assets; in the former case, the termination of the corporation's business results from the transfer of its assets in a sale or exchange and the dis-

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[12] H.Rept. 1337, 83d Cong., 2d Sess. (1954), pp. A111-A-112; S.Rept. 1622, 83d Cong., 2d Sess. (1954), p. 49.

tribution must consist of proceeds of such transfer "attributable" to the cessation of business.

Departing from a literal and ordinary reading of the statute, the court below held that the distribution of all of the stock of Northwest was not attributable to Pacific's ceasing to conduct the businesses in the northwest states, since Pacific failed to distribute *all of the proceeds* which it received as a result of its termination of business activities in those states (Appx. C, infra, p. 52A). Seemingly, it adopted the Tax Court's holding that the failure by Pacific to distribute the $200 million note received from Northwest was the basis for its finding that all of the proceeds received by Pacific were not distributed by it to its shareholders (R.A. 108).[13] The court's reasoning was based on the assumption that the reference in section 346(b) to "the assets" implied that all the assets must be distributed in order to qualify. It then found that a distribution "attributable" to a cessation of business was meant to be treated in a fashion parallel to the distribution of assets. It found that the alleged failure to distribute all of the proceeds of the transfer to Northwest was fatal to the taxpayers' case.

The court stated that the legislative history of section 346(b) supported this conclusion (Appx. C, infra, p. 52A, n. 5). However, the Second Circuit relied on statements in the report of the Ways and Means Committee[14] which

[13]In passing, it should be noted that even if the court below is correct in holding that all of the proceeds must be distributed, this test is satisfied since Pacific did distribute to its shareholders all of the stock of Northwest, which represented the entire net assets of the businesses transferred to Northwest.

[14]H.Rept. 1337, 83d Cong., 2d Sess. (1954), p. A112.

dealt with a quite different version of the definition of partial liquidation (H.R. 8300, 83d Cong., 2d Sess. §336 (1954), House version), one which the Senate did not adopt[15] and which did not become law. The parallel between the two types of distributions afforded partial liquidation treatment is in the *termination of the business* which is the *source* of the liquidating distribution. There is no question here but that Pacific terminated its business in the northwest states by a transfer of the assets of such business to Northwest. Equally, the distribution of the proceeds of that transfer, i.e., the Northwest stock, was attributable to the cessation of the business resulting from such transfer.

The transaction here was clearly capital in nature. The Northwest stock represented to the Pacific shareholders part of the capital which they had committed to the venture. Sound business reasons and logic call for giving the language of section 346 its natural meaning, and according capital gain treatment, under taxpayers' alternative contention, to the receipt of the Northwest stock which was attributable to Pacific's terminating its business in the northwest states. The Second Circuit's novel interpretation of provisions designed to provide assurance to taxpayers in the treatment of partial liquidating distributions should be rejected. This Court should grant review to re-establish the statutory standards finally adopted by Congress, not those employed in the House version which were eliminated from the provisions ultimately enacted in section 346(b).

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[15] S.Rept. 1622, 83d Cong., 2d Sess. (1954), p. 49.

CONCLUSION

For the foregoing reasons, this petition for a writ of certiorari should be granted.

Respectfully submitted,

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(Appendices Follow)

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Appendix A

SEC. 346. PARTIAL LIQUIDATION DEFINED.

(a). In General.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562 (b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) Termination of a Business.—A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction

in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(e) TREATMENT OF CERTAIN REDEMPTIONS.—The fact that, with respect to a shareholder, a distribution qualifies under section 302 (a) (relating to redemptions treated as distributions in part or full payment in exchange for stock) by reason of section 302 (b) shall not be taken into account in determining whether the distribution, with respect to such shareholder, is also a distribution in partial liquidation of the corporation.

SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(3) CROSS REFERENCE.—

For treatment of the exchange if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) CROSS REFERENCE.—

For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368 (a) (1) (D), see section 355.

* * * * *

SEC. 368. DEFINITIONS RELATING TO CORPORATE REORGANIZATIONS.

(a) REORGANIZATION.—

(1) IN GENERAL.—For purposes of parts I and II and this part, the term "reorganization" means—

(A) a statutory merger or consolidation;

(B) the acquisition by one corporation, in exchange solely for all or a part of its voting stock, of stock of another corporation if, immediately after the acquisition, the acquiring corporation has control of such other corporation (whether or not such acquiring corporation had control immediately before the acquisition);

(C) the acquisition by one corporation, in exchange solely for all or a part of its voting stock (or in exchange solely for all or a part of the voting stock of a corporation which is in control of the acquiring corporation), of substantially all of the properties of another corporation, but in determining whether the exchange is solely for stock the assumption by the acquiring corporation of a liability of the other, or the fact that property acquired is subject to a liability, shall be disregarded;

(D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which

the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356;

(E) a recapitalization; or

(F) a mere change in identity, form, or place of organization, however effected.

(2) SPECIAL RULES RELATING TO PARAGRAPH (1).—

(A) REORGANIZATIONS DESCRIBED IN BOTH PARAGRAPH (1) (C) AND PARAGRAPH (1) (D).—If a transaction is described in both paragraph (1) (C) and paragraph (1) (D), then, for purposes of this subchapter, such transaction shall be treated as described only in paragraph (1) (D).

(B) ADDITIONAL CONSIDERATION IN CERTAIN PARAGRAPH (1) (C) CASES.—If—

(i) one corporation acquires substantially all of the properties of another corporation,

(ii) the acquisition would qualify under paragraph (1) (C) but for the fact that the acquiring corporation exchanges money or other property in addition to voting stock, and

(iii) the acquiring corporation acquires, solely for voting stock described in paragraph (1) (C), property of the other corporation having a fair market value which is at least 80 percent of the fair market value of all of the property of the other corporation.

then such acquisition shall (subject to subparagraph (A) of this paragraph) be treated as qualifying under paragraph (1) (C). Solely for the purpose of determining whether clause (iii) of the preceding sentence

applies, the amount of any liability assumed by the acquiring corporation, and the amount of any liability to which any property acquired by the acquiring corporation is subject, shall be treated as money paid for the property.

(C) TRANSFERS OF ASSETS TO SUBSIDIARIES IN CERTAIN PARAGRAPH (1) (A) AND (1) (C) CASES.—A transaction otherwise qualifying under paragraph (1) (A) or paragraph (1) (C) shall not be disqualified by reason of the fact that part or all of the assets which were acquired in the transaction are transferred to a corporation controlled by the corporation acquiring such assets.

(b) PARTY TO A REORGANIZATION.—For purposes of this part, the term "a party to a reorganization" includes—

(1) a corporation resulting from a reorganization, and

(2) both corporations, in the case of a reorganization resulting from the acquisition by one corporation of stock or properties of another.

In the case of a reorganization qualifying under paragraph (1) (C) of subsection (a), if the stock exchanged for the properties is stock of a corporation which is in control of the acquiring corporation, the term "a party to a reorganization" includes the corporation so controlling the acquiring corporation. In the case of a reorganization qualifying under paragraph (1) (A) or (1) (C) of subsection (a) by reason of paragraph (2) (C) of subsection (a), the term "a party to a reorganization" includes the corporation controlling the corporation to which the acquired assets are transferred.

* * * * *

Appendix B

[1032]* OSCAR E. BAAN AND EVELYN K. BAAN, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

IRVING GORDON AND MARGARET GORDON, PETITIONERS v. COMMISSIONER OF INTERNAL REVENUE, RESPONDENT

Dockets Nos. 949-63, 3949-63. Filed March 26, 1969.

In a corporate spin-off whereby Pacific corporation transferred to newly created Northwest corporation a portion of its business operations partly in exchange for Northwest stock, the shares of North-**[1033]** west were distributed to Pacific stockholders (or their assignees) by means of stock rights that were issued in two separate offerings about 2 years apart. It was held in *Commissioner v. Gordon*, 391 U.S. 83, that the nonrecognition provisions of sec. 355, I.R.C. 1954, were inapplicable to upset the Commissioner's determination that Pacific's stockholders received taxable dividends in the amount of the difference between the value of the Northwest stock and the cash that the stockholders were required to pay in order to obtain that stock. Upon remand, *held* that the treatment of the amounts in question as dividends was similarly not precluded by the nonrecognition provisions of sec. 354 or the provisions relating to partial liquidations in sec. 346.

Harry R. Horrow and *Stephen J. Martin*, for the petitioners.

Richard K. Seltzer, for the respondent.

*Figures in brackets refer to pages of the Official Tax Court Reports, Vol. 51.

OPINION

RAUM, *Judge:* These cases are before us on remands from the Second and Ninth Circuits, following the decision of the Supreme Court herein. *Commissioner v. Gordon*, 391 U.S. 83. We made complete findings of fact when the cases were in this Court the first time (45 T.C. 71), and the facts have been summarized not only by the two Courts of Appeals, 382 F. 2d 485 (C.A. 9); 382 F. 2d 499 (C.A. 2), but also by the Supreme Court itself. We refer to our previous findings for a full account of the events involved and will now set forth only an abbreviated version thereof.

Prior to July 1, 1961, Pacific Telephone & Telegraph Co. (Pacific) conducted its telephone and other communications business in California, Oregon, Washington, and Idaho. During all of 1961 the outstanding capital stock of Pacific consisted of 104,756,943 shares of common stock and 820,000 shares of cumulative preferred stock. At all times during 1961, American Telephone & Telegraph Co. (A. T. & T.) owned 90.25 percent of Pacific's outstanding common stock and 78.17 percent of Pacific's outstanding preferred stock, or an aggregate of 89.62 percent of the total voting power of Pacific. The minority common and preferred shares were publicly held by over 38,000 shareholders, and have been traded on the New York Stock Exchange and the Pacific Coast Stock Exchange. Petitioners Baan, residents of California, and petitioners Gordon, residents of New York, were among these minority stockholders: the Baans owned 600 shares of Pacific common and the Gordons owned 1,540 shares of Pacific common.

As a result of the vast expansion of Pacific's telephone and other communication business it was decided early in 1961 to divide Pacific's operations into two separate corporations by transferring its Oregon, Washington, and Idaho business (about 20 percent of its total business) to a new corporation created for that purpose, Pacific North-
[1034] west Bell Telephone Co. (Northwest). Northwest was organized in March 1961, with an authorized capital stock of 50 million shares of one class common having a par value of $1 per share. Pacific at once purchased 10,000 of those shares for $10,000 in cash. Subsequently, on June 30, 1961, after approval by various governmental regulatory agencies, Pacific transferred to Northwest all the assets pertaining to the Oregon, Washington, and Idaho business. In return Pacific received 30,450,000 Northwest shares, a $200 million demand note payable by Northwest to Pacific, and the assumption by Northwest of outstanding liabilities (with certain exceptions) relating to the operations in the three States. As of July 1, 1961, Northwest commenced operations in the newly carved-out territory.

The foregoing transfers were made pursuant to a "Plan For Reorganization of the Pacific Telephone and Telegraph Company" which was approved by the stockholders of Pacific at their annual meeting on March 24, 1961. The plan contemplated the distribution of the Northwest stock by Pacific to its own stockholders through the medium of issuing stock purchase rights to them. Thus, the sale of the Northwest stock pursuant to such rights would provide Pacific with cash to pay its own existing liabilities as well as to meet additional

capital needs of Pacific over a period of years. The raising of such cash for Pacific was an important objective of the plan, in addition to dividing the business between two separate corporations for purposes of efficiency in management. The plan, however, did not require the distribution of all the Northwest stock at once. To the contrary, only some 56 percent of that stock (enough to pass control of Northwest to A.T.&T.) was thus to be distributed immediately, and the plan stated that it was "expected" that the remaining stock would similarly be offered for sale within about 3 years in one or more offerings. The plan also provided that Pacific's board of directors would determine the prices at which the shares would be offered at the time of each offering. By thus spacing the offerings the subsequent distribution or distributions of the shares would be made at such time or times as to be coordinated with Pacific's need for new capital.

In accordance with the plan, Pacific on September 29, 1961, issued to its common stockholders one right for each outstanding share of Pacific.[1] Six rights plus a payment of $16 in cash were required to purchase one share of Northwest. The rights were transferable and expired some 3 weeks later, on October 20, 1961. The rights thus issued were sufficient to support a transfer of some 57.3 percent of the North- **[1035]** west stock. No other offering was made in 1961, and the remaining 43 percent was

[1]Under the plan, A.T.&T. gave up 1,253,301 rights from the total rights (94,542,139) which it would otherwise have been entitled to receive, and the rights thus relinquished by A.T.&T. were given to the minority preferred stockholders on the basis of seven rights for each share of preferred held by them. A.T.&T. received no rights with respect to its preferred shares of Pacific.

offered to the Pacific shareholders in a second and final offering on June 12, 1963, under similar conditions except that eight rights plus $16 were required to purchase one share of Northwest.

The Northwest stock was listed on the American Stock Exchange and the Pacific Stock Exchange, and trading with respect to such stock and the 1961 stock rights commenced on September 14, 1961, on a when-issued basis. The average price of the stock on certain days set forth in the record between September 14 and October 20, 1961, ranged from $29.8126 to $26; and the corresponding average price for the rights on those days ranged from $2.234375 to $1.65625.

As a result of the 1961 offering the minority common and preferred shareholders or their assignees acquired 1,897,891 shares of Northwest common by exercising rights, and A.T.&T. similarly acquired 15,548,140 shares. The tofal fair market value of these shares was $468,852,920, and the cash received by Pacific therefor was $279,136,496. In the consolidated income tax return of A.T.&T. and its affiliates for 1961 gain in the amount of $8,739,362.07 was reported by Pacific in respect of the Northwest shares sold to the minority stockholders (no gain was reported in respect of the shares sold to A.T.&T. by reason of the consolidated return).

As a result of Pacific's second and final offering it disposed of all of the remaining 43 percent Northwest shares in like manner in 1963, and A.T.&T. emerged with 89.1 percent of the Northwest stock.

Petitioners Baan exercised all of the 600 rights issued to them in 1961: they paid $1,600 cash to Pacific on Octo-

ber 11, 1961, and acquired 100 shares of Northwest. The Gordons similarly exercised 1,536 of the 1,540 rights issued to them in 1961 and acquired 256 shares of Northwest, paying $4,096 to Pacific on October 5, 1961. On the same day they sold the four remaining rights for the net amount of $6.36.

In determining the deficiencies against the Baans the Commissioner ruled that $1,094, the difference between the fair market value of the 100 shares of Northwest acquired by them ($2,694) and the cash paid in connection with such acquisition ($1,600), was taxable as a dividend. He similarly determined that $2,800.24, the difference between the fair market value[2] of the 256 shares of Northwest ($6,896.64) acquired by the Gordons and the cash paid by them ($4,096), was taxable as a dividend. Also, in his answer in the *Gordon* case, the Commissioner sought to increase taxable income by the amount realized upon the sale of the four remaining rights which the Gordons had received.

[1036] As was indicated in our previous opinion (45 T.C. at 87), as well as in the opinions of the Ninth Circuit (382 F. 2d at 489) and the Supreme Court (391 U.S. at 90),[3] the spread between the value of the Northwest stock and the sales price (at $16 a share) constituted taxable dividends,[4] as determined by the Commissioner,

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[2] There is no dispute as to the fair market value determined by the Commissioner with respect to the shares purchased by either the Baans or the Gordons.

[3] See also dissenting opinion of Judge Friendly in the Second Circuit (382 F. 2d at 510).

[4] The record established that Pacific had sufficient earnings and profits to support the treatment of such spread as dividends in respect of the stock owned not only by petitioners but also by all other shareholders of Pacific.

unless some provision of the 1954 Code requires different treatment. Petitioners argued that dividend treatment was precluded by any one of three different provisions of the Code: Sections 355 and 354, either of which would render petitioners' gains free of tax altogether, if applicable, and section 346 which would subject those gains to the more favorable capital gains treatment. Petitioners placed their principal reliance upon section 355, dealing with divisive reorganizations. We agreed with petitioners' position in this respect and held that the gains which they realized and which were reflected in the Northwest stock received by them were entitled to nonrecognition under section 355. In our view the transfer of the Oregon-Washington-Idaho business to Northwest was truly a spin-off and was carried out in such manner as to bring into play the nonrecognition provisions of section 355. We therefore found it unnecessary to consider petitioners' alternative contentions under sections 354 or 346. The courts of appeals divided on the applicability of section 355, and in resolving the conflict between the two circuits the Supreme Court held that section 355 was inapplicable, relying upon a ground which had not been argued before us and which was advanced in this litigation for the first time on appeal (391 U.S. at 95 fn. 8). Upon remand, we are now required to pass upon petitioners' alternative contentions not heretofore adjudicated and to determine whether they are entitled to prevail either under section 354 or section 346. We hold that neither section 354 nor section 346 is applicable, and that accordingly the Commissioner's determination must be sustained.

I. Applicability of Section 354

The sale by Pacific of the Northwest stock to its stockholders at $16 a share at a time when that stock had a fair market value of somewhat in excess of $26 a share represented a distribution of Pacific's property to the extent of the difference. And as has previously been established in this litigation, see above, that distribution must be treated as a taxable dividend unless some provision of the 1954 Code commands otherwise. The principal provisions now relied upon by petitioners are contained in section 354, which provides:

[1037] SEC. 354. EXCHANGES OF STOCK AND SECURITIES IN CERTAIN REORGANIZATIONS.

(a) GENERAL RULE.—

(1) IN GENERAL.—No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) LIMITATION.—Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

* * * * * * *

(b) EXCEPTION.—

(1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) Cross Reference—

For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368 (a) (1) (D), see section 355.

Petitioners contend that the Northwest stock which they received and which comprehended the dividend charged to them by the Commissioner were received in an exchange governed by section 354 (a) (1), with the result that the gain reflected in such stock was entitled to nonrecognition.

Assuming *arguendo* that the transaction before us qualifies as a "reorganization" within the definitional provision of section 368 (a) (1)—a matter upon which we shall comment hereinafter—it seems clear to us that section 354 does not give petitioners the nonrecognition which they seek. This is so for any one of a number of reasons. We shall set forth several of them.

1. Section 354 (a) (1) is applicable only "if stock or securities in a corporation a party to a reorganization are * * * exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization." These provisions by their very terms do not fit this case. Granted that petitioners received solely stock of Northwest, a party to the reorganization, there

was no "exchange" of "stock or securities" therefor. This was simply a case of a *sale* of Northwest stock at $16 a share pursuant to an offer made by Pacific that was embodied in the rights or warrants that had been issued to its stockholders. They gave up nothing. They merely paid $16 a share for the Northwest stock which they acquired.

[1038] Certainly, petitioners *exchanged no* "stock or securities" to obtain the Northwest shares, an explicit requirement of the statute. In an attempt to escape from the unhappy consequence of this situation, however, petitioners argue (a) that they in fact did exchange securities (at least in part) for the Northwest shares when they surrendered their rights and (b) that "an exchange of stock under section 354 can occur where no stock certificates leave the hands of the exchanging shareholders or come into their hands from the acquiring corporation." We think there is no merit to either of these points.

(a) The Ninth Circuit has already held in this litigation that "Stock rights are not stocks or securities." 382 F. 2d at 492. Cf. *William H. Bateman*, 40 T.C. 408; *Helvering v. Southwest Corp.*, 315 U.S. 194. To be sure, rights have been held in certain circumstances to be the equivalent of stock, cf. *Carlberg v. United States*, 281 F. 2d 507 (C.A. 8); *James C. Hamrick*, 43 T.C. 21; but the particular instruments involved in those cases represented direct contingent interests in the respective corporations and were not options to purchase stock. In any event, we regard as far more authoritative here the Ninth Circuit's views which were announced when considering the very rights before us now. While the matter under consider-

ation then was the term "stock or securities" in section 355(a)(1)(A), we think that a like meaning must be accorded to that term in the closely related provisions of section 354, regardless of whether these words may be interpreted differently in a different part of the Code or in a different context.

As petitioners themselves have stated in another connection in their brief, the rights issued by Pacific were "merely offers," and "Their sole purpose and effect was to act as a vehicle for the transfer of the Northwest stock to the Pacific shareholders, conditioned on their payment of cash to Pacific." Although petitioners undoubtedly transmitted their pieces of paper embodying the rights to Pacific (or its fiscal agent) when they purchased the Northwest stock at $16 a share, they were merely accepting Pacific's offer to sell the stock at that price, and were not "exchanging" securities, even in part, for such Northwest shares.

(b) Nor is there any substance to petitioners' contention that an "exchange" can occur under section 354 even where no stock certificates leave the hands of the exchanging stockholders. Petitioners cite in this connection a number of cases, of which *Commissioner v. Morgan*, 288 F. 2d 676 (C.A. 3), and *James Armour, Inc.*, 43 T.C. 295 are typical. They arise in an entirely different context, and hold in substance, for example, that where the sole stockholder of the transferor is already the sole stockholder of the transferee, additional stock of the transferee need not be issued to him or to the transferor because the exchange requirement does not call for such "meaningless gesture" [1039] (*James Armour, Inc.*, 43

T.C. at 307). No such unusual circumstances are present here that could justify ignoring the plain requirement of the statute that there be an exchange of "stock or securities" for the Northwest stock which petitioners received.[5]

2. We now consider what we previously assumed *arguendo*, namely, whether there was compliance with the underlying requirement of section 354 that there be a "reorganization" in order to bring into play the specific nonrecognition provisions of section 354. For these purposes the term "reorganization" is defined in section 368 (a) (1), which sets forth six types of corporate readjustments that can qualify as "reorganizations." These are contained in six separate subparagraphs identified respectively from (A) to (F). Petitioners contend that the transaction before us qualified as a "reorganization" under either (D) or (F). In our view, there was neither a (D) nor an (F) reorganization here.

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[5]Such exchange of Pacific stock would not have been a meaningless gesture. The rights were not issued in strict accordance with stock ownership in Pacific, for A.T.&T. received no rights in respect of its preferred stock and it received a diminished number of rights in respect of its common shares of Pacific, the difference being allocated to the minority preferred. The manner in which the transaction was carried out did in fact permit some distortion as among the various stockholders. Moreover, the record shows that only some 65 percent of the 38,000 minority stockholders (in respect of some 88 percent of the outstanding minority stock) exercised their rights; most of the remaining rights were sold, thus permitting strangers to become stockholders of Northwest, and a small percentage of the rights lapsed without exercise. Although the ultimate difference in terms of percentages of stock ownership was perhaps minor, a large number of shareholders were nevertheless involved and there is no basis for ignoring the plain words of the statute on the extraordinary ground that to comply with it would have been a "meaningless gesture."

(a) Section 368 (a) (1) (D) defines a (D) reorganization as follows:

> (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under sections 354, 355, or 356;

These provisions incorporate by reference sections 354, 355, and 356, and it is only section 354 that is pertinent in this case. But here again the plain words of section 354 are fatal to petitioners' position. In this connection section 354 (b) provides:

> (b) EXCEPTION.—
>
> (1) IN GENERAL.—Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368 (a) (1) (D), unless—
>
> (A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and
>
> (B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

[1040] These provisions explicitly rule out nonrecognition in respect of an exchange pursuant to a plan or re-

organization under section 368(a)(1)(D) unless two specific conditions are satisfied. And in this case neither of those conditions has been met.

(i) The first condition demands that the corporation to which the assets are transferred (Northwest) acquire "substantially all of the assets of the transferor (Pacific) of such assets." In the present case, however, Pacific transferred only the Oregon-Washington-Idaho business to Northwest, retaining for itself the California business, and the record indicates that the transferred business constituted only about 20 percent of Pacific's entire operations. Surely, it would require an extraordinary flight of fancy to characterize the transferred assets as comprising "substantially all" of Pacific's assets. To be sure, as we recognized in *John G. Moffatt*, 42 T.C. 558, 578, affirmed 363 F. 2d 262 (C.A. 9), certiorari denied 386 U.S. 1016, the term "substantially all" is a relative term dependent on the facts of any particular situation, and it may apply to a transfer of all of the corporation's business assets even where certain nonoperating assets are retained by the transferor. But that case and others similarly relied upon by petitioners are wholly out of point here. For in the present case, Pacific retained the great bulk of its *operating* assets, namely, those relating to the conduct of its California business. We find no basis in the statute to support petitioners' unusual view that the "substantially all" requirement is met if only the transferor conveys all the assets of *a* business (here the Northwest business) while retaining the operating assets pertaining to the conduct of its remaining business. The statutory language does not permit so distorted a reading.

Cf. *Edward H. Russell*, 40 T.C. 810, affirmed per curiam 345 F. 2d 534 (C.A. 5).

(ii) The second condition of section 354 (b) (1) requires that the "stock, securities, and other properties" received by the transferor (Pacific) "as well as the other properties of such transferor" be distributed in pursuance of the plan of reorganization. There has been failure to comply with this condition in at least two respects. *First*, among the "other properties" received by Pacific from Northwest was a $200 million note, and this was not distributed. *Second*, Pacific did not distribute its own "other properties." We find unconvincing petitioners' attempt to explain away these vital deficiencies in their position.

Accordingly, failure to comply with the various requirements of section 354 in this case automatically precludes the existence of a (D) reorganization by reason of the very terms of (D) itself which require that the transactions qualify under section 354.[6]

[1041] Moreover, as a result of the first condition in section 354 (b) (1), it can be seen that no spin-off is entitled to nonrecognition under section 354 as a (D) reorganization, and the Government has argued that Congress intended that all divisive reorganizations must go through the route of section 355 in order to achieve nonrecognition. There is much force to this position. As recounted herein by the Ninth Circuit (382 F. 2d at 491),

[6]The transaction may also qualify under sec. 355 or 356. But it has already been held by the Supreme Court that sec. 355 is inapplicable here, and petitioners have not contended that sec. 356 governs apart from the applicability of sec. 354.

Congress in 1934, recognizing the potential for widespread tax avoidance, completely eliminated the provisions permitting tax-free spin-offs. There the matter stood until 1951, when in response to legitimate business needs, it was decided to reinstate the tax-free character of the spin-off, subject, however, to carefully formulated conditions that were intended to be safeguards against abuse. These new provisions, as substantially revised and expanded, were included in section 355 of the 1954 Code. It would seem highly persuasive that Congress, showing so much concern for preventing tax abuse through utilization of the spin-off device, understood that nonrecognition in connection with a spin-off or other divisive reorganizations could be achieved exclusively by compliance with the specially formulated safeguards set forth in section 355 and could not be attained by alternate routes such as section 354. The basic purpose of the detailed restrictive conditions in section 355 would be defeated if distributions in connection with divisive reorganizations were allowed to qualify under section 354, and evidence of congressional intention in this respect is found in the very enactment of section 354 (b) (1). The Government relies upon certain legislative history in support of this view. See also Bittker and Eustice, Federal Income Taxation of Corporations and Shareholders 492-493 (2d ed. 1966).

Further evidence of the legislative intention that section 355 be the exclusive test for divisive reorganizations is found in section 368 (a) (2) (A) which provides that transactions qualifying as both (C) and (D) reorganizations shall be treated as only (D) reorganizations. The

Senate Finance Committee explained this provision as follows (S. Rept. No. 1622, 83d Cong., 2d Sess., p. 274):

> "Your committee intends by this rule [sec. 368 (a) (2) (A)] to insure that the tax consequences of the distribution of stocks or securities to shareholders or security holders in connection with divisive reorganization will be governed by the requirements of section 355 relating to distribution of stock of a controlled corporation.

Thus, if section 355 provides the exclusive avenue to nonrecognition in connection with a spin-off or other divisive reorganizations, petitioners must fail in their claim to tax-free acquisition of the Northwest stock in the bargain purchase before us, since the Supreme Court has already ruled that section 355 is inapplicable here. However, we need not pass upon this point, for it is clear to us that section 354 in any event does not provide the nonrecognition which petitioners seek.

[1042] (b) Nor is the necessary existence of a "reorganization" supplied by section 368 (a) (1) (F) which defines a reorganization as including "(F) a mere change in identity, form, or place of organization, however effected."

Relying upon the considerations discussed above the Government argues that Congress did not regard any divisive reorganizations as qualifying under (F). In its reply brief it states:

> Since Congress clearly intended to funnel divisive changes in corporate structure through Section 355 via Section 368 (a) (1) (D), the fact that Congress did not also mention Section 368 (a) (1) (F) in Section 368 (a) (2) (A) proves that Congress did not

conceive that such changes could be considered "F" reorganizations. Acceptance of the petitioners' contention on this point would result in the destruction of Congress' carefully designed method for determining the tax consequences of distributions incident to divisive changes in corporate structure.

Here too, although this argument appears to be persuasive, we need not go that far in this case, for we think that in any event there was no "mere" change in identity, form, or place of organization. The changes involved were far too substantial to satisfy the "mere" requirement.

In *Estate of Bernard H. Stauffer*, 48 T.C. 277, we gave careful and extensive consideration to the definition of an (F) reorganization. While it is true that we were reversed in that case, 403 F. 2d 611 (C.A. 9), we do not find it necessary here to reexamine the conclusions which we reached there, because, in our view, the restructuring of Pacific's business was of such fundamental character that it could not qualify in any event as a "mere" change in identity, form, or place of organization.

It must be remembered that the division of Pacific into two corporations was brought about primarily by the vast expansion of Pacific's business, with the concomitant necessity of providing separate, independent management for that segment of the operations that was conducted in the three northwest states. After the corporate readjustment neither Pacific's officers nor its board of directors would be in control of the Northwest business. Northwest was created as an entirely new corporation with independent control and supervision of the telephone and communications business in the Oregon-Washington-

Idaho territory. It became completely separated from Pacific, and conducted its business autonomously wholly free from Pacific's control. And indeed there were even changes in stockholdings. To be sure, A.T.&T. continued to be the majority and dominant stockholder, but it must also be recalled that there were some 38,000 minority stockholders, and that there were numerous shifts in such minority holdings. Accordingly, regardless of *Stauffer*, we find on this record that, **[1043]** considering the changes in the aggregate, they were so basic as to preclude the conclusion that there was a "mere" change in identity, form, or place of organization under (F). For this reason, as well as the others discussed above, we hold that petitioners have failed to bring themselves within the nonrecognition provisions of section 354.

II. Applicability of Section 346

Petitioners contend that if section 354 does not apply to the transactions involved herein, then the distribution of the Northwest stock should be treated as one made in partial liquidation within the meaning of section 346, in particular section 346(b). Section 331 (a) (2) provides that amounts "distributed in partial liquidation of a corporation (as defined in section 346) shall be treated as in part or full payment in exchange for the stock." Thus if section 346 applies here petitioners' gain will be taxable as capital gain. Secs. 1001, 1201, 1221. We hold that section 346 is inapplicable.

Section 346 provides in pertinent part:

> SEC. 346. PARTIAL LIQUIDATION DEFINED.
>
> (a) IN GENERAL.—For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562 (b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) TERMINATION OF A BUSINESS.—A distribution shall be treated as a distribution described in subsection (a)(2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of, a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

(c) TREATMENT OF CERTAIN REDEMPTIONS.— * * *

[1044] The Commissioner urges that section 346 is inapplicable for a number of reasons. We consider only several of them.

1. Since there was no redemption of Pacific shares, the Commissioner contends that section 346 can be of no avail to petitioners. Petitioners, on the other hand, argue that a redemption is not required. They rely upon section 346 (b) as providing the exclusive test here, and since section 346 (b) makes no mention of redemption they conclude that none is necessary. The Commissioner counters by pointing out that a redemption is required by section 346 (a) (2), and takes the position that section 346 (b) was intended merely to define a specific instance of a distribution "not essentially equivalent to a dividend" within the meaning of section 346 (a) (2) and was not intended to dispense with the redemption and other requirements of section 346 (a) (2), the operative provisions involved.

It must be admitted that section 346 as a whole, and the introductory sentence of subsection (b) in particular, are not wholly free from ambiguity. That sentence reads "A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met." If Congress meant to say, as petitioners contend, that the

satisfaction of (b) (1) and (2) alone results in a distribution in partial liquidation, it would seem that Congress would have made (b) an operative provision like (a) (1) and (a) (2) rather than by routing its operative effort through (a) (2). If on the other hand section 346 (b) merely provides a "nonequivalence to a dividend" safe-harbor to be applied through (a) (2), as the Commissioner contends, it would have been an easy matter to begin (b) by saying "a distribution shall be considered not essentially equivalent to a dividend for the purpose of subsection (a) (2) if—." Compare secs. 302 (b) (1) and 302 (b) (2). We must of course deal with the actual language of the statute, however unsatisfactory it may be. We have not been referred to any case dealing with section 346 (b), and the legislative history of the section does not provide a conclusive answer to our problem. We find, however, that the Commissioner's reading of the statute is more consistent with its purpose than is the petitioners' interpretation.

Section 346 (b) does not stand alone, and it is not operative by its own force. Rather, it sets forth certain criteria whereby a distribution is to be governed by subsection (a) (2). But the problem which gave particular difficulty in determining whether a distribution fell within (a) (2) was whether it was "essentially equivalent to a dividend." And the provisions of (b) were enacted to remove that troublesome question [1045] provided that certain specified conditions were met.[7] In our view, section

[7] That this was the purpose of (b) is confirmed in "Summary of the New Provisions of the Internal Revenue Code of 1954," a published document prepared by the Staff of the Joint Committee on Internal Revenue Taxation. At p. 38 of that Summary,

346 (b) merely describes a distribution that will automatically be considered as "not essentially equivalent to a dividend" within the meaning of (a) (2). The statute contains the operative provisions of the statute which we think cannot be ignored, one of them being a requirement that there must be a redemption—a wholly unrelated and easily ascertainable condition for a partial liquidation. Unless (a) (2) and (b) are thus construed as interdependent relationship there would have been no point whatever in making the effectiveness of (b) depend from the operative provisions of (a) (2); (b) standing by its own force would have required the result petitioners claim for it.

Further, the test of section 346 (b)—the essentially active business—was prior to the 1954 Code the judicial test for determining whether a distribution was "essentially equivalent to a dividend" under section 115 (g) of the 1939 Code. See Bittker & Redlich, "Corporate Liquidation and the Income Tax," 5 Tax L. Rev. 391, 465-473, and the cases cited therein at n. 178. Section 346 (b) was designed to provide in specific terms a definition of a corporate contraction that would in most cases satisfy in that respect the test of a partial liquidation. But we can see no reason [illegible] and none has been

referring to sec. 346 (b), it is stated: "The statute describes one kind of distribution which is deemed not to be essentially equivalent to a dividend and, therefore, qualifies as a liquidation." While the Summary does not have the same force that may be attributed to reports of the congressional committees themselves, it is helpful in an effort to understand the background of the legislation. This is particularly true in connection with the 1954 Code which represented a substantial undertaking by Congress to enact the most comprehensive revision of the tax laws in history, an undertaking in which the committees played an important role.

to our attention) why Congress would intend to dispense with the condition that there be a redemption of stock.

In sum, we agree with the Commissioner's contention that subsection (a) is the operative portion of section 346 while subsection (b) merely describes a situation in which the dividend nonequivalence test of section 346 (a) (2) is met without further inquiry. The other requirements of that section, including the redemption requirement, must still be met. As previously indicated, we must interpret the statute as we find it, clumsy draftsmanship and all, and it is our best judgment, taking into account the reason for enacting (b) as well as its dependence upon (a) (2) for operative effect, that this is what Congress intended.

Petitioners go on to argue, however, that recent cases under section 346 (a) (2) show that no actual surrender of shares is necessary to have a "redemption." Petitioners rely primarily on *Fowler Hosiery Co.*, 36 **[1046]** T.C. 201, affirmed 301 F. 2d 394 (C.A. 7). That case involved a payment from a subsidiary to its parent. After finding that the distribution was made pursuant to a plan of liquidation, the Court faced the fact that no stock was surrendered. We found that fact to be immaterial because there was only one shareholder whose interest would remain the same regardless of how many shares of stock were surrendered. 36 T.C. at 221.

Some cases under the 1939 Code involved much discussion of what would satisfy the "cancellation and redemption" requirement of section 115 (i) of that Code, the ancestor of section 346. Compare *John K. Beretta*, 1 T.C. 86, affirmed 141 F. 2d 452 (C.A. 5), certiorari denied

323 U.S. 720, with *Rynum v. Commissioner*, 113 F. 2d 1 (C.A. 5), and *Commissioner v. Straub*, 76 F. 2d 388 (C.A. 3). The present statute, however, does not contain the term "cancellation,"[8] and we think that *Fowler* quite properly regarded an actual surrender as meaningless in a sole shareholder situation. The Commissioner himself in a series of rulings has shown an appreciation that in a prorata distribution situation the surrender of stock certificates is a purely formal act. In Rev. Rul. 56-513, 1956-2 C.B. 191, it was held that in determining the amount of gain realized in a distribution in partial liquidation the actual amount of stock surrendered is of no significance, but rather an amount of stock shall be *deemed* to have been surrendered which bears the same proportion to the total number of shares outstanding as the amount distributed bears to the net corporate assets prior to the distribution. See also, Rev. Rul. 68-348 I.R.B. 1968-27, 14; Rev. Rul. 59-240, 1959-2 C.B. 112; Rev. Rul. 57-334, 1957-2 C.B. 240.

Nevertheless, granting the correctness of the *Fowler* principle, that principle was based on the fact of a strict prorata distribution, which was not the case here. Since the rights were not distributed prorata and since some of the rights were sold, there would not have been a prorata redemption of shares had Pacific shares been surrended for Northwest shares. Thus, an actual redemption would not have been meaningless. Since there was no actual or constructive redemption, the distribution of the Northwest

[8]It should be noted that the definition of "redemption" in sec. 317 applies only to part 1 of subch. C, which does not include sec. 346.

stock cannot be treated as a distribution in partial liquidation under section 346.

2. We also agree with the Government's alternative contention that section 346 (b) is inapplicable for the further reason that Pacific did not distribute all the proceeds of the transfer to Northwest. We hold that section 346 (b) properly construed, does require a com-
[1047] plete distribution of the proceeds attributable to the corporate contraction. Section 346 (b) (1) covers two types of distributions: (1) One that "is attributable to the corporation's ceasing to conduct * * * a trade or business," etc., and (2) one that "consists of the assets of, a trade or business," etc. The first type deals with proceeds and the second deals with assets. The second speaks of "*the* assets," not merely "assets," and the inference is clear that the meaning is *all* the assets. Since the two types of distribution are clearly meant to be parallel, we must conclude that *all* the proceeds must be distributed as well. Cf. sec. 1.346-1 (b)(2), Income Tax Regs. This interpretation serves the purpose of the section: if all the proceeds of the transfer of an active business are not distributed to the shareholders, the shareholders would still have an interest in the transferred business inherent in their stock in the transferor, and the rationale for giving a distribution capital gain treatment would not be present.

This interpretation is borne out by the legislative history. The Senate report, speaking of section 346 (b), states: "Under this rule, if a corporation is engaged in two or more active businesses which has [sic] been carried on for at least 5 years, it may distribute *the* assets

of either one of the businesses in kind, or *the* proceeds of their sale." (Emphasis added.) S. Rept. No. 1622, 83d Cong., 2d Sess., p. 49. See also *id.* at 262. Further, the Senate version of section 346 (b) was based on section 336 (a) of the House version of the 1954 Code (H.R. 8300, 83d Cong., 2d Sess.). The House provision required the distribution in partial liquidation to be "attributable to the complete termination of one of at least two businesses." The House report on that section stated:

> The requirement that the distribution be "attributable to" the complete termination of a business is intended to mean that the assets distributed are *all of those*, but only those, which were necessary to the conduct of the business terminated or were received in exchange for all or part of such assets upon a disposition in connection with the liquidation. [Emphasis added. H. Rept. No. 1337, 83d Cong., 2d Sess., p. A112.]

While the House provision was quite different from that ultimately enacted as section 346, the words "attributable to" as defined in the House report are used in the same manner as in the section as enacted, and there is no reason to believe that they were intended to have a different meaning in the section as enacted. See also Mertens, Law of Federal Income Taxation, Code Commentary, vol. I, sec. 346 (b) :2 (commenting on sec. 346 (b)):

> Apparently, all the assets of the business which were [sic] conducted during the five-year period must be distributed. In other words, although all of such assets may have been sold, it does not appear that only half of the proceeds of the sale **[1048]** may be distributed and the other half retained for rein-

vestment in the active business which is still conducted by the distributing corporation.

Pacific failed to distribute all the proceeds of the transfer to Northwest in three rspects. First, the $200 million demand note was not distributed. Second, the payment by Pacific shareholders of $16 per Northwest share in effect constituted the retention by Pacific of a substantial amount of the proceeds of the transfer to Northwest. Finally, the Northwest stock was distributed in two steps. The Supreme Court dealt with the problems caused by the separate distributions in connection with section 355. We need not decide, however, whether the Supreme Court's reasoning concerning that section applies also to section 346. Suffice it to say that the two distributions cannot be regarded as one transaction in the present context because section 346 (a) (2) requires a distribution pursuant to a plan and occurring no later than the taxable year following the adoption of the plan. It is clear that the second distribution here (in 1963) did not fall within such a period.

III. Four Rights Sold By The Gordons

Petitioners Gordon appear to attempt to reopen the question as to the proper tax treatment of the $6.36 proceeds which they received upon their sale of the four residual rights. Our decision in this respect was reversed by the Second Circuit which in turn was reversed by the Supreme Court. The issue in respect of these four rights was raised only in the Gordons' appeal to the Second Circuit, and in its mandate to us, following the Supreme Court's decision, it was "ordered, adjudged and

decreed that on the Taxpayer's appeal said order [the order of this Court] be and it hereby is affirmed." We do not regard the issue relating to the sale of the rights as being open any longer.

The Government has made an extensive argument on remand in connection with all the rights distributed by Pacific, to the effect that the dividend income taxable to the stockholders is the value of the rights upon distribution rather than the spread between the value of the Northwest shares and the $16 purchase price as of the date of the bargain purchase. The deficiencies herein were determined on the basis of the latter theory, and the Commissioner has not sought to amend his pleadings to ask for any increased deficiency based upon his revised theory. In the circumstances, we do not consider it, and we do not reexamine the conclusions stated by us in this respect when these cases were previously here. 45 T.C. at 87.

Decisions will be entered under Rule 50.

Appendix C

[378] Irving GORDON and Margaret Gordon,
Petitioners-Appellants,
v.
COMMISSIONER OF INTERNAL REVENUE,
Respondent-Appellee.

No. 316, Docket 33772.
United States Court of Appeals,
Second Circuit.

Argued Feb. 4, 1970.
Decided March 16, 1970.

[380] WATERMAN, Circuit Judge:

By this appeal this case reaches our court for the second time. The taxpayers, husband and wife, were minority shareholders in the Pacific Telephone and Telegraph Company (Pacific), 89% of the stock of which was owned by the American Telephone and Telegraph Company (A T & T). Pacific, a California corporation, did business not only in that state but also in Oregon, Washington, and Idaho. In 1961 the management of Pacific decided to simplify its administration by dividing Pacific into two corporations, each of which would be owned directly by Pacific's contemporary shareholders. Pacific would transfer to a new company all its operations outside California. Considerations of state law led the management to decide against distributing stock in the new corporation pro rata to the shareholders, whether or not in redemption of

*Figures in brackets refer to pages of 424 Federal Reporter, 2d Series.

Pacific shares which they held.[1] Instead, it was decided to create a new subsidiary of Pacific, called the Pacific Northwest Bell Telephone Company (Northwest), a State of Washington corporation. In return for receiving Pacific's assets in Washington, Oregon, and Idaho, Northwest issued all its stock to Pacific and also assumed a proportionate share of Pacific's long term debt by issuing a demand promissory note to Pacific for $200,000,000.[2]

This plan of reorganization was adopted in 1961 by the shareholders. The plan required Pacific to offer its Northwest stock to the Pacific shareholders in two or more offerings. The first of these, to involve more than half the Northwest shares, was to take place shortly after the creation of Northwest. The timing of later offerings would depend on Pacific's need for capital, for the Northwest stock would be offered to the shareholders for cash in connection with the stock rights previously issued to them.

Accordingly, on September 29, 1961, Pacific issued to its shareholders rights to acquire about 57% of the Northwest stock, which rights were to remain valid for three weeks. Six rights plus $16 had to be offered for each share of Northwest. The remaining 43% of the Northwest

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[1] Pacific did not have enough earned surplus to cover a pro rata distribution of Northwest stock. Apparently such a distribution would have been treated as a dividend under California law. Pacific's brief also states that a redemption of Pacific stock in return for Northwest stock would have required Pacific to redeem all its voting preferred, a redemption which the corporation did not consider feasible.

[2] This note was repaid by Northwest about two years later with funds raised by several issues of its own long term debentures.

stock was offered in 1963, at a rate of 8 rights plus $16 per each Northwest share. In these two offerings A T & T exercised all its rights and the owners of half of the remaining 11% of Pacific's shares also exercised their rights. The remaining rights—about 5% of the total—either were not exercised by anyone or were exercised by persons to whom they had been publicly traded by Pacific's minority shareholders.

The present tax dispute grows out of the 1961 offering. The Gordons, who filed a joint return for that year, exercised their rights to acquire 256 shares of Northwest, worth $6656 or $26 per share on the date of exercise. In addition to surrendering their stock rights, they paid the required $16 per share for each of the 256 shares, a total of $4096. The Commissioner sought to tax as a dividend the difference between the cash amount paid and the value received, and the Gordons repaired to the Tax Court. There they argued that the receipt of the [381] Northwest stock was tax free under Sections 355 and 354 of the Internal Revenue Code, or alternatively, that the amount treated by the Commissioner as a dividend should instead be taxed as a capital gain under Section 346. The Tax Court agreed with the taxpayers that, pursuant to Section 355, the so-called "spinoff" provision, the gain need not be recognized, and therefore that court did not decide taxpayers' claims under Section 354 or 346. The decision of the Tax Court was affirmed by this court, 382 F.2d 499 (2 Cir. 1967). The Supreme Court reversed, however, 391 U.S. 83, 88 S.Ct. 1517, 20 L.Ed.2d 448 (1968), holding that the requisite control of Northwest had not passed to Pacific's shareholders in 1961, and the case was remanded to the Tax Court for it to consider taxpayers'

other claims. After this remand the Tax Court then held, 51 T.C. 1032, that neither Section 354 nor Section 346 is applicable to the situation at bar and accorded the taxpayers no relief. The taxpayers appeal and seek review of this adverse holding. We affirm the Tax Court.

Section 354

The Tax Court held for two main reasons that the Pacific-Northwest reorganization failed to come within the terms of Section 354 which we have quoted in pertinent part in the margin.[3] Judge Raum speaking for that court

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[3] Sec. 354. Exchanges of stock and securities in certain reorganizations.

(a) General rule.

(1) In general.

No gain or loss shall be recognized if stock or securities in a corporation a party to a reorganization are, in pursuance of the plan of reorganization, exchanged solely for stock or securities in such corporation or in another corporation a party to the reorganization.

(2) Limitation.

Paragraph (1) shall not apply if—

(A) the principal amount of any such securities received exceeds the principal amount of any such securities surrendered, or

(B) any such securities are received and no such securities are surrendered.

(b) Exception.

(1) In general.

Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a)(1)(D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

(2) Cross reference.

For special rules for certain exchanges in pursuance of plans of reorganization within the meaning of section 368(a)(1)(D), see section 355.

held, first, that the taxpayers had not exchanged "stock or securities" for the Northwest stock they received, as Section 354(a) (1) requires, and that there was no reorganization as defined in Section 368(a)(1)(E). See Sec. 354(b) (1).

We agree with Judge Raum that the Northwest stock rights which taxpayers surrendered for the Northwest stock did not amount to the "stock or securities" which the statute requires be exchanged for the stock or securities being distributed if no gain or loss is to be recognized. Appellants cite Miles v. Safe Deposit & Trust Co., 259 U.S. 247, 252, 42 S.Ct. 477, 479 (1922) for the proposition that because stock rights embody the right to receive stock in the corporation, the rights represent an equity in the corporation and can reasonably be termed a "stock or security." Cf. Commissioner v. United States, 281 F.2d 307 (8th Cir. 1960); Commissioner v. Hamrick, 43 T.C. 21 (1965). Moreover, appellants argue that the rights do not represent an equity in Northwest for that corporation had not been formed at the time the rights were issued, but, instead, represent an equity interest in a segregated portion of the assets of Pacific.

We do not find these arguments persuasive. It would be difficult to define the [382] stock rights as "securities" without facing a quandary, for securities are expressly defined as "property" by Section 317(a) and, as such, distributions of securities by a corporation to its shareholders are, therefore, when distributed, taxable under Section 301 as distributions of property. It is of no benefit to appellants to obtain tax-free treatment of the exercise

rights if the initial distribution to them of these rights is taxable to the extent of the value of the rights when distributed. According to the evidence before us taxpayers' taxable gain would appear to be the same in either case. On the facts here it is of course possible for taxpayers to argue that an equity interest constituting a "security" for purposes of Section 354 may not constitute a "security" for purposes of Section 317, but no justification for drawing such a distinction has been suggested. Indeed, if made, we would reject the argument. Therefore we find it unnecessary to decide whether the stock rights distributed by Pacific constituted securities within the meaning of Section 354.

So in order for taxpayers to be benefited by this litigation taxpayers must show that the rights constituted "stock" within the meaning of Section 354(a). We do not agree that they did, for several reasons. First, the qualities which normally typify "stock" do not exist. These warrants represented no present voting or dividend rights in Pacific and represented no right to share, in themselves, in the assets of Pacific if that corporation were liquidated except to the limited extent that Pacific could be compelled to divest itself of Northwest before Pacific were liquidated. In short, the rights were only binding offers to the shareholders of the stock of Pacific's subsidiary. Taxpayers argue that this binding offer to them constituted an enforceable equity in Pacific's assets, and, because an enforceable equity, was stock in Pacific. This argument proves too much. If it were valid, nearly any executory promise of a corporation to convey its assets to another party would constitute "stock" in the promisor corporation. Such a construction flies in the face of

normal understanding and usage. Moreover, the Commissioner points out that the stock rights offering did not convey an interest in the undifferentiated total assets of Pacific as stock normally does, but only in a particular segregated portion of those assets. Taxpayers again cite Miles v. Safe Deposit & Trust Co., *supra*, 259 U.S. 247, 252, 42 S.Ct. 483 (1922) for the proposition that distribution by a corporation of stock rights is equivalent to a distribution of stock. However, in that case the corporation distributed rights in its *own* stock. If the case is at all relevant to our case it demonstrates that Pacific's distribution of rights to buy Northwest stock was equivalent to a distribution of Northwest stock, not Pacific stock. Compare Carlberg v. United States, 281 F.2d 507 (8 Cir. 1960), with Commissioner of Internal Revenue v. Baan, 382 F.2d 485 (9 Cir.), aff'd sub nom. Commissioner of Internal Revenue v. Gordon, 391 U.S. 83, 88 S.Ct. 1517, 20 L.Ed.2d 448 (1968). Moreover, Helvering v. Southwest Consol. Corp., 315 U.S. 194, 200-201, 62 S.Ct. 546, 86 L. Ed. 789 (1942) would seem conclusively to dispose of the notion that stock warrants are generally equivalent to the stock of the obligor corporation for purposes other than the purposes treated in Miles v. Safe Deposit & Trust Co., *supra*. In Helvering v. Southwest Consol. Corp., which involved the meaning of "voting stock" for purposes of the reorganization provisions of the 1939 Code, the Court stated:

> [T]he warrants which were issued were not "voting stock." Whatever rights a warrant holder may have "to require the obligor corporation to maintain the integrity of the shares" covered by the warrants * * * he is not a shareholder. * * * His rights are wholly contractual. As stated by Holmes, J., in Par-

> kinson v. West End Street Ry., 173 Mass. 446, 448, 53 N.E. 891, 892, he "does not become a stockholder, by his contract, in [383] equity any more than at law." At times his right may expire on the consolidation of the obligor corporation with another. Id. If at the time he exercises his right there are no authorized and unissued shares to satisfy his demand, he will get damages not specific performance. * * * Thus he does not have, and may never acquire, any legal or equitable rights in shares of stock. * * * And he cannot assert the rights of a shareholder. Id.

We also note that Sections 305 and 317 except from dividend treatment both the distribution of the corporation's own stock and the distribution of rights to acquire such stock, thus codifying the rule set forth in Eisner v. McComber, 252 U.S. 189, 40 S.Ct. 189, 64 L.Ed. 521 (1920) and in Miles v. Safe Deposit & Trust Co., *supra*. The fact that the Internal Revenue Code speaks of stock and stock rights separately, even when the rights to obtain stock are rights to obtain stock of the distributing corporation, weighs heavily against taxpayers' assertion that, for tax purposes, the two are the same and there is no distinction between them. Equally important is the fact that these sections, 305 and 317, just cited, mention only rights to acquire stock of the distributing corporation and do not mention rights to acquire shares in the stock of other corporations held in its investment portfolio by the distributing corporation.

We do not understand taxpayers to argue that even if the issue of stock rights to them should be treated for tax purposes as a stock dividend of Northwest stock as opposed to Pacific stock so that Section 354 does not

apply, the issuance of such rights would be nonetheless free from taxation either when issued or when exercised because not intended as a distribution of earnings or profits. See Palmer v. Commissioner of Internal Revenue, 302 U.S. 63, 58 S.Ct. 67, 82 L.Ed. 50 (1937) and Choate v. Commissioner of Internal Revenue, 129 F.2d 684 (2 Cir. 1942). Consequently we consider the issue waived and do not reach the question of the continued validity of these cases under the 1954 Code. See Carlson, Taxation of "Taxable" Stock Rights: The Strange Persistance of Palmer v. Commissioner, 23 Tax L.Rev. 129 (1968).

We find it unnecessary to pass upon the Tax Court's determination that no "exchange" took place within the meaning of Section 354. We recognize that taxpayers' exercise of the stock rights replaced certain legal interests with other legal interests. However, inasmuch as the section speaks of an exchange of stock and securities for other stock and securities, we find it irrelevant whether, in some sort of an abstract way, the surrender of something other than stock or securities amounted to an "exchange."

We now turn to the Tax Court's second principal ground for denying taxpayers the utilization of Section 354, namely, that Pacific was not "a party to a reorganization" within the contemplation of Section 354. More specifically, the Tax Court held that even if a corporate reorganization of some sort did in fact occur, it would necessarily be the kind of reorganization defined by Section 368(a) (1) (D), which Section 354 excludes from tax-free treatment. Section 354(b) reads as follows:

(b) Exception.

(1) In general.

Subsection (a) shall not apply to an exchange in pursuance of a plan of reorganization within the meaning of section 368(a) (1) (D), unless—

(A) the corporation to which the assets are transferred acquires substantially all of the assets of the transferor of such assets; and

(B) the stock, securities, and other properties received by such transferor, as well as the other properties of such transferor, are distributed in pursuance of the plan of reorganization.

The Tax Court held that these conditions so spelled out in the statute were not met inasmuch as Pacific (1) did not [384] transfer substantially all its assets to Northwest, and (2) Pacific did not distribute all the stock and securities it received from Northwest in return—namely, the $200,000,000 note and that portion of the Northwest stock which was not distributed until 1963.

On appeal taxpayers do not challenge the Tax Court's ruling that Section 354 is inapplicable if a reorganization is judged to have taken place under Section 368(a) (1) (D). Instead, they argue that the court erred in refusing to denominate the transaction a Section 368(a) (1) (F) reorganization to which the requirements of Section 354(b) do not apply.

We are less certain than the court below that the transaction here could not qualify for some purposes as a reorganization under subparagraph (F) of Section 368(a) (1), namely, as "a mere change in identity, form, or

place of organization, however effected." The transaction was motivated by valid business purposes related to more efficient business administration. If the statutory phrase "mere change in form" can be read only to require that the transaction may not principally be used as a dividend mechanism, arguably that condition was met here. Cf. Section 355(a) (1) (B). Although a number of cases have pointed to a complete identity of shareholders before and after the transaction as evidence that the corporation had undergone a mere change in form, see, e.g., Associated Machine v. Commissioner of Internal Revenue, 403 F.2d 622, 625 (9 Cir. 1968); Estate of Stauffer v. Commissioner of Internal Revenue, 403 F.2d 611, 618 (9 Cir. 1968); Davant v. Commissioner of Internal Revenue, 366 F.2d 874, 884 (5 Cir. 1966), cert. denied, 386 U.S. 1022, 87 S.Ct. 1370, 18 L.Ed.2d 460 (1967), it is not clear thus far whether such an identity is an indispensable condition to the invocation of Section 368(a) (1) (F).

However, we do not find it necessary to determine whether this provision can apply to the transaction at bar. Even if subparagraph (F) applies, the transaction in this case is one which would also be a reorganization under subparagraph (D) were it not for the specific limitations which Section 354(b) places on such transactions. We do not believe that these limitations become inapplicable simply because this [illegible] sort of erstwhile (D) reorganization which might also qualify as a "mere change in form."

It seems clear that a reorganization which qualifies as a "mere change in form" under Section 368(a) (1) (F)

can qualify under other parts of Section 368 as well. See Estate of Stauffer v. Commissioner of Internal Revenue, *supra* at 617-618. Section 368(a) (1) (D) defines a reorganization as follows:

> (D) a transfer by a corporation of all or a part of its assets to another corporation if immediately after the transfer the transferor, or one or more of its shareholders (including persons who were shareholders immediately before the transfer), or any combination thereof, is in control of the corporation to which the assets are transferred; but only if, in pursuance of the plan, stock or securities of the corporation to which the assets are transferred are distributed in a transaction which qualifies under section 354, 355, or 356.

This language would include any spin-off where control remained in the parent corporation or its shareholders as long as the shares are distributed in a transaction which qualifies under Section 354, 355, or 356. The cross-reference to Section 354 can produce a kind of *renvoi*, for Section 354(b) in turn states that Section 354 will not apply to reorganizations which qualify under Section 368(a) (1) (D) unless certain conditions are met. If we go behind these circular references in search of the congressional meaning, it seems clear that divisive reorganizations, in which a corporation transfers property to a second corporation, are meant to be granted tax-free status under Section 354 only if the conditions of Section 354(b) are met.

[385] The Tax Court was correct in holding that these conditions were not met. Northwest, the corpora-

tion to which the assets were transferred, did not acquire "substantially" all of the assets of Pacific. Nor can it be said that in pursuance of the plan of reorganization Pacific distributed the stock, securities, and other properties which Pacific received. Pacific never at any time distributed the $200,000,000 note it received from Northwest. As to the stock, 43% remained undistributed at the end of the tax year in question, and the corporation had no obligation to distribute the remainder at any definite date in the future. See Commissioner of Internal Revenue v. Gordon, 391 U.S. 83, 95-98, 88 S.Ct. 1517 (1968). Consequently, the transaction failed to meet the requirements of either part of Section 354(b).

These requirements seem to bar the present transaction from the haven of Section 354 even if the transaction can be found to qualify as "a mere change in form" under Section 368(a) (1) (F). If Section 354(b) did not exist, the present transaction would clearly qualify as a (D) reorganization. Equally clearly, Section 354(b) exists to prevent it from so qualifying. Doubtless the reason for this prevention is to insure that all spin-offs will be judged by the standards of Section 355 rather than by the standards of Section 354. To thwart that plain congressional intention by calling the transaction a "mere change in form" would be erroneous. Alternatively, it seems fair to say that a divisive reorganization should not qualify as a mere change in form for purposes of Section 354 unless it meets the standards of either Section 354(b) or Section 355.

We therefore hold that taxpayers may not bring themselves within the non-recognition provisions of Section 354.

Section 346

Taxpayers contend that if they are not entitled to the non-recognition provisions of Section 354, they should receive capital gains treatment under Section 346, which section is set forth in the margin.[4] The Tax Court rejected [386] this contention on several grounds, and we agree with the Tax Court.

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[4] § 346. Partial liquidation defined.

(a) In general.

For purposes of this subchapter, a distribution shall be treated as in partial liquidation of a corporation if—

(1) the distribution is one of a series of distributions in redemption of all of the stock of the corporation pursuant to a plan; or

(2) the distribution is not essentially equivalent to a dividend, is in redemption of a part of the stock of the corporation pursuant to a plan, and occurs within the taxable year in which the plan is adopted or within the succeeding taxable year, including (but not limited to) a distribution which meets the requirements of subsection (b).

For purposes of section 562(b) (relating to the dividends paid deduction) and section 6043 (relating to information returns), a partial liquidation includes a redemption of stock to which section 302 applies.

(b) Termination of a business.

A distribution shall be treated as a distribution described in subsection (a) (2) if the requirements of paragraphs (1) and (2) of this subsection are met.

(1) The distribution is attributable to the corporation's ceasing to conduct, or consists of the assets of a trade or business which has been actively conducted throughout the 5-year period immediately before the distribution, which trade or business was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

(2) Immediately after the distribution the liquidating corporation is actively engaged in the conduct of a trade or business, which trade or business was actively conducted throughout the 5-year period ending on the date of the distribution and was not acquired by the corporation within such period in a transaction in which gain or loss was recognized in whole or in part.

Whether or not a distribution meets the requirements of paragraphs (1) and (2) of this subsection shall be determined without regard to whether or not the distribution is pro rata with respect to all of the shareholders of the corporation.

Taxpayers assert that their transaction, which admittedly does not fit the specifications of Section 346(a) (1), need not fit the requirement of Section 346(a) (2) which specifies that there be a redemption of a part of the corporation's stock pursuant to a plan. They contend that Section 346(b) states that a distribution will fulfill the requirements of Section 346(a) (2) if two conditions are met, and these conditions do not appear to demand that the distribution be a distribution in redemption.

It is true, as the Tax Court recognized, that the function of Section 346(b) is ambiguous. Section 346(a) (2) contains three requirements: nonequivalency to a dividend, redemption of stock, and occurrence of the distribution within the same or succeeding taxable year as that in which the plan of redemptive distribution is adopted. Subsection (b) states that a distribution will be deemed to be one "described in subsection (a) (2)" if two conditions are met: the distribution must be attributable to the cessation of a business which the distributing corporation conducted during the previous five years, and the distributing corporation, after the distribution, must continue in a business which it also conducted during the previous five years. The distribution need not be pro rata to qualify.

It is not altogether clear whether Congress intended that compliance with subsection (b) should waive any further need to comply with the three separate requirements of subsection (a) (2). However, it is certainly plausible that Congress intended by the enactment of subsection (b) that whenever a corporation ceases a business entirely and distributes the assets or proceeds,

the distribution should be regarded as a return of capital even when no redemption takes place and even when the actual distribution is delayed for more than two years despite the (a) (2) provision. Unlike the Tax Court, we do not pass upon this question for we find that the requirements of Section 346(b) have not been met in this case because Pacific failed to distribute or to commit itself to distribute, all the proceeds which it received as a result of its termination of business activities in Washington, Oregon, and Idaho.

Subsection (b) (1) requires that the distribution be "attributable to" the corporation's ceasing to conduct business or, in the alternative, that the distribution consist of "the assets" of the terminated business. We agree with the Commissioner and the Tax Court that the reference to "the assets" clearly implies that all the assets must be distributed in order to qualify. Inasmuch as a distribution "attributable to" a cessation of business is obviously meant to be treated in a fashion parallel to the distribution of assets, we hold that a failure to distribute all such proceeds is fatal to taxpayers' case. The legislative history of the provision supports this conclusion.[5]

[5]The Senate Report on Section 346(b) speaks of "the assets" and "the proceeds." S.Rep.No.1622, 83d Cong., 2d Sess. at 49, U.S. Code Cong. & Admin.News 1954, p. 4629. Similarly, the House version of the bill, in an earlier form, stated that "The requirement that the distribution be 'attributable to' the complete termination of a business is intended to mean that the assets distributed are *all of those*, but only those, which were necessary to the conduct of the business terminated or were received in exchange for all or part of such assets upon a disposition in connection with the liquidation." (Emphasis supplied.) H.Rep. No.1337, 83d Cong., 2d Sess. at A112, U.S.Code Cong. & Admin. News 1954, p. 4250.

This holding draws support not only from linguistic inference but also from policy. Where a corporation ceases to conduct a discrete portion of its business and distributes the entire assets of this [387] segment of operation or the proceeds thereof to the shareholders, Congress has provided that the distribution be treated not as a return of profits but as a return to the shareholders of part of the capital which they had contributed to the original venture. If all the actual capital assets of the business or all the proceeds thereof resulting from the business from a disposition of those assets are being distributed, this treatment is an eminently [illegible] However, between this situation and the hypothetical case where the corporation distributes only a small portion of the assets or the proceeds of their sale, Section 341 draws no line apparent to this court. It seems reasonably clear, moreover, that the hypothetical case mentioned is not one which deserves to be called a partial liquidation. Indeed, it constitutes nothing more than a reinvestment in another line of business of the capital that was used in the terminated business with the result that there occurs relatively little contraction in the size of the activities of the corporation as a whole. Because the intellectual concept of a partial liquidation is itself a tenuous one and difficult to securely support by intuition, from the concept of a distribution we feel compelled to grasp the only certain standard of differentiation which we can see and to require that all the assets of a liquidated business, or all the proceeds thereof, be distributed before the transaction can qualify under Section 346(b). Otherwise, the distribution [illegible]

action must meet the somewhat more detailed provisions of Section 346(a) (2).

For these reasons we conclude that the Pacific-Northwest transaction did not meet the requirements of Section 346(b), and, as no redemption occurred, it also failed to meet the requirements of Section 346(a) (2).

Affirmed.

Appendix D

[83]* COMMISSIONER OF INTERNAL REVENUE *v.* GORDON ET UX.

CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT.

No. 760. Argued April 4, 1968.—Decided May 20, 1968.**

Pacific Telephone & Telegraph Co. (Pacific), a subsidiary of American Telephone & Telegraph Co., which owned about 90% of Pacific's stock, transferred certain of its assets to a new company, Pacific Northwest Bell Telephone Co. (Northwest), in exchange for all Northwest's common stock, and debt paper. In 1961 Pacific distributed to its shareholders rights to purchase about 57% of Northwest's common stock at $16 a share, which was below its market value. Pacific advised its shareholders that "it expected that within about three years . . . the Company by one or more offerings will offer for sale the balance of such stock." It also reported that the Internal Revenue Service had ruled that stockholders who sold rights distributed to them would receive taxable income in the amount of the proceeds of sale, and that stockholders who exercised rights would receive taxable income in the amount of the difference between $16 and the fair market value per share of Northwest stock obtained. In 1963 the remaining Northwest stock was similarly offered to Pacific stockholders through rights. Respondents in No. 760 were minority stockholders of Pacific who received rights pursuant to

*Figures in brackets refer to pages of 391 U.S.

**Together with No. 781, *Baan et ux. v. Commissioner of Internal Revenue*, on certiorari to the United States Court of Appeals for the Ninth Circuit.

the 1961 distribution; they sold four rights and exercised the balance. Petitioners in No. 781, who also received rights in 1961, exercised them all. None of these individuals reported any income from these transactions on their tax returns and the Commissioner of Internal Revenue asserted deficiencies. The Tax Court upheld the taxpayers' contention that the 1961 spinoff distribution met the requirements of § 355 of the Internal Revenue Code of 1954, with the result that no gain should be recognized on the receipt or exercise of the rights. The Tax Court held that the sale of the four rights did result in ordinary income. No. 781 was appealed to the Court of Appeals for the Ninth Circuit which reversed the Tax Court and held that the difference between $16 [84] and fair market value was taxable income. No. 760 was appealed to the Second Circuit, which sustained the Tax Court on this point, but held the amount received from the sale of the rights was taxable as a capital gain rather than income. *Held:*

1. When a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the corporation's net worth, it is engaging in a "distribution of property," and such a sale results in a dividend to shareholders unless some specific exception applies. Pp. 88-91.

2. Section 355 of the Code does not provide an exception for the 1961 distribution. Pp. 91-98.

(a) The 1961 distribution did not transfer "all" the Northwest stock nor did it transfer "control" (defined in § 368(c) as 80%), within the meaning of § 355 (a)(1)(D). Pp. 91-95.

(b) For an initial transfer of less than a controlling interest to be treated as merely the first step in the divestiture of control it must be clearly identifiable as such at the time it is made and there must be a binding commitment to take the later steps, which was not the situation here. Pp. 95-98.

(c) Since receipt and exercise of the rights produced ordinary income, receipt and sale of the rights also resulted in income taxable at ordinary rates. P. 98.

No. 760, 382 F. 2d 499, reversed; No. 781, 382 F. 2d 485, affirmed.

Solicitor General Griswold argued the cause for petitioner in No. 760 and for respondent in No. 781. With him on the briefs were *Assistant Attorney General Rogovin, Harris Weinstein, Gilbert E. Andrews,* and *Martin T. Goldblum.*

Harry R. Horrow argued the cause for respondents in No. 760 and for petitioners in No. 781. With him on the briefs were *Francis N. Marshall* and *Stephen J. Martin.*

MR. JUSTICE HARLAN delivered the opinion of the Court.

These cases, involving the interpretation of § 355 of the Internal Revenue Code of 1954, have an appropriately complex history.

[85] American Telephone and Telegraph Company (hereafter A. T. & T.) conducts its local communications business through corporate subsidiaries. Prior to July 1, 1961, communications services in California, Oregon, Washington, and Idaho were provided by Pacific Telephone and Telegraph Company (hereafter Pacific).

A. T. & T. held about 90% of the common stock of Pacific at all relevant times. The remainder was widely distributed.

Early in 1961, it was decided to divide Pacific into two separate corporate subsidiaries of A. T. & T. The plan was to create a new corporation, Pacific Northwest Bell Telephone Company (hereafter Northwest) to conduct telephone business in Oregon, Washington, and Idaho, leaving the conduct of the California business in the hands of Pacific. To this end, Pacific would transfer all its assets and liabilities in the first three States to Northwest, in return for Northwest common stock and debt paper. Then, Pacific would transfer sufficient Northwest stock to Pacific shareholders to pass control of Northwest to the parent company, A. T. & T.

Pacific had, however, objectives other than fission. It wanted to generate cash to pay off existing liabilities and meet needs for capital, but not to have excess cash left over. It also feared that a simple distribution of the Northwest stock would encounter obstacles under California corporation law.[1] Consequently, the "Plan for Reorganization" submitted to Pacific's shareholders on [86] February 27, 1961, had two special features. It provided that only about 56% of the Northwest common stock would be offered to Pacific shareholders immediately

[1]The record indicates that Pacific's attorneys had advised that if Pacific distributed the Northwest shares without payment of consideration by Pacific's shareholders, the distribution would have to be charged to earned surplus; the attorneys further advised that Pacific had insufficient earned surplus for this purpose, and that if this difficulty were avoided by creation of a reduction surplus, the reduction surplus would, under California law, have to be used first to redeem Pacific's preferred shares.

after the creation of Northwest. It also provided that, instead of simply distributing Northwest stock pro rata to shareholders, Pacific would distribute to its shareholders transferable rights entitling their holders to purchase Northwest common from Pacific at an amount to be specified by Pacific's Board of Directors, but expected to be below the fair market value of the Northwest common.

In its February 27 statement to shareholders, Pacific said that it was seeking a ruling from the Internal Revenue Service

> "with respect to the tax status of the rights to purchase which will be issued in connection with the offerings of capital stock of the New Company to shareholders of the Company . . . ."

The statement warned, however, that "[t]axable income to the holders of such shares may result with respect to such rights."

The plan was approved by Pacific's shareholders on March 24, 1961. Pacific transferred its assets and liabilities in Oregon, Washington, and Idaho to Northwest, and ceased business in those States on June 30, 1961. On September 29, 1961, Pacific issued to its common stockholders one right for each outstanding share of Pacific stock. These rights were exercisable until October 20, 1961. Six rights plus a payment of $16 were required to purchase one share of Northwest common. The rights issued in 1961 were sufficient to transfer about 57% of the Northwest stock.

By September 29, 1961, the Internal Revenue Service had ruled that shareholders who sold rights would real-

[87] ize ordinary income in the amount of the sales price, and that shareholders who exercised rights would realize ordinary income in the amount of the difference between $16 paid in and the fair market value, measured as of the date of exercise, of the Northwest common received. The prospectus accompanying the distributed rights informed Pacific shareholders of this ruling.

On June 12, 1963, the remaining 43% of the Northwest stock was offered to Pacific shareholders. This second offering was structured much as the first had been, except that eight rights plus $16 were required to purchase one share of Northwest.

The Gordons, respondents in No. 760, and the Baans, petitioners in No. 781, were minority shareholders of Pacific as of September 29, 1961. In the rights distribution that occurred that day the Gordons received 1,540 rights under the plan. They exercised 1,536 of the rights on October 5, 1961, paying $4,096 to obtain 256 shares of Northwest, at a price of $16 plus six rights per share. The average price of Northwest stock on the American Stock Exchange was $26 per share on October 5. On the same day, the Gordons sold the four odd rights for $6.36. The Baans received 600 rights on September 29, 1961. They exercised them all on October 11, 1961, receiving 100 shares of Northwest in return for their 600 rights and $1,600. On October 11, the agreed fair market value of one Northwest share was $26.94.

In their federal income tax returns for 1961, neither the Gordons nor the Baans reported any income upon the receipt of the rights or upon exercising them to obtain Northwest stock at less than its fair market value. The

Gordons also did not report any income on the sale of the four rights. The Commissioner asserted deficiencies against both sets of taxpayers. He contended, in a joint proceeding in the Tax Court, that the taxpayers received [88] ordinary income in the amount of the difference between the sum they paid in exercising their rights and the fair market value of the Northwest stock received. He contended further that the Gordons realized ordinary income in the amount of $6.36, the sales price, upon the sale of their four odd rights.

The Tax Court upheld the taxpayers' contention that the 1961 distribution of Northwest stock met the requirements of § 355 of the Code, with the result that no gain or loss should be recognized on the receipt by them or their exercise of the rights. The Tax Court held, however, that the Gordons' sale of the four odd rights resulted in ordinary income to them. The Commissioner appealed the *Baan* case to the Court of Appeals for the Ninth Circuit, and the *Gordon* case to the Court of Appeals for the Second Circuit; in the latter, the Gordons cross-appealed. The Ninth Circuit reversed the Tax Court, holding that the spread between $16 and fair market value was taxable as ordinary income to the Baans. The Second Circuit disagreed, sustaining the Tax Court on this point in the *Gordon* case, Judge Friendly dissenting. The Second Circuit went on to hold that the amount received by the Gordons for the four odd rights was taxable as a capital gain rather than as ordinary income, reversing the Tax Court on this point.

Because of the conflict, we granted certiorari. 389 U. S. 1033, 1034. We affirm the decision of the Court of

Appeals for the Ninth Circuit, and reverse the decision of the Court of Appeals for the Second Circuit on both points.

Under §§ 301 and 316 of the Code, subject to specific exceptions and qualifications provided in the Code, any distribution of property by a corporation to its shareholders out of accumulated earnings and profits is a divi- [89] dend taxable to the shareholders as ordinary income.[2] Every distribution of corporate property, again except as otherwise specifically provided, "is made out of earnings and profits to the extent thereof."[3] It is here agreed that on September 28, 1961, Pacific's accumulated earnings and profits were larger in extent than the total amount the Commissioner here contends was a dividend—the difference between the fair market value of all Northwest stock sold in 1961 and the total amount, at $16 per share, paid in by purchasers.

Whether the actual dividend occurs at the moment when valuable rights are distributed or at the moment when their value is realized through sale or exercise, it is clear

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[2]Section 301 (a) provides as follows:
"Except as otherwise provided in this chapter, a distribution of property (as defined in section 317 (a)) made by a corporation to a shareholder with respect to its stock shall be treated in the manner provided in subsection (c)."
Section 317 (a) provides that "the term 'property' means money, securities, and any other property . . . ." Section 301 (c) provides that the "portion of the distribution which is a dividend (as defined in section 316) shall be included in gross income." Section 316 says that "the term 'dividend' means any distribution of property made by a corporation to its shareholders—(1) out of its earnings and profits accumulated after February 28, 1913, or . . ."

[3]Section 316 (a) provides in part as follows:
"Except as otherwise provided in this subtitle, every distribution is made out of earnings and profits to the extent thereof . . . ."

that when a corporation sells corporate property to stockholders or their assignees at less than its fair market value, thus diminishing the net worth of the corporation, it is engaging in a "distribution of property" as that term is used in § 316.[4] Such a sale thus results in a [90] dividend to shareholders unless some specific exception or qualification applies. In particular, it is here agreed that the spread was taxable to the present taxpayers unless the distribution of Northwest stock by Pacific met the requirements for nonrecognition stated in § 355, or § 354, or § 346 (b) of the Code.[5] Since the Tax

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[4] See, *e. g., Choate v. Commissioner*, 129 F. 2d 684 (C. A. 2d Cir.). In *Palmer v. Commissioner*, 302 U. S. 63, 69, this Court said:

"While a sale of corporate assets to stockholders is, in a literal sense, a distribution of its property, such a transaction does not necessarily fall within the statutory definition of a dividend. For a sale to stockholders may not result in any diminution of its net worth and in that case cannot result in any distribution of its profits.

"On the other hand such a sale, if for substantially less than the value of the property sold, may be as effective a means of distributing profits among stockholders as the formal declaration of a dividend."

In *Palmer*, rights were distributed entitling shareholders to purchase from the corporation shares of stock in another corporation. Finding that the sales price represented the reasonable value of the shares at the time the corporation committed itself to sell them, this Court found no dividend. It held that the mere issue of rights was not a dividend. It has not, however, been authoritatively settled whether an issue of rights to purchase at less than fair market value itself constitutes a dividend, or the dividend occurs only on the actual purchase. In the present case this need not be decided.

[5] It is important to begin from this premise. In our view, the Court of Appeals for the Second Circuit erred in its approach to the § 355 problem because it assumed, at the outset, that the Commissioner essentially sought to tax a transaction that brought no "income" to Pacific shareholders. Whether the shareholders received income, however, cannot in practice be determined in the abstract, before looking at § 355.

Any common shareholder in some sense "owns" a fraction of the assets of the corporation in which he holds stock, including

Court [91] concluded that the requirements of § 355 had been met, it did not reach taxpayers' alternative contentions. Under the disposition that we make here upon the § 355 question, these alternative contentions remain open for further proceedings in the Tax Court.

Section 355 provides that certain distributions of securities of corporations controlled by the distributing corporation do not result in recognized gain or loss to the distributee shareholders.[6] The requirements of the

those assets that reflect accumulated corporate earnings. Earnings are not taxed to the shareholder when they accrue to the corporation, but instead when they are passed to shareholders individually through dividends. Consequently it does not help to note, as the Second Circuit here did, that the distribution of Northwest stock merely changed the form of ownership that Pacific's shareholders enjoyed and did not increase their wealth. This is only very roughly true at best, but in the rough sense in which it is here true, it is true of any dividend. The question is not whether a shareholder ends up with "more" but whether the change in the form of his ownership represents a transfer to him, by the corporation, of assets reflecting its accumulated earnings and profits.

There may be a genuine theoretical difference between a change in form representing a mere corporate fission, separating what the shareholder owns into two smaller but essentially similar parts, and a change in form representing a dividend, separating what a shareholder owns *qua* shareholder from what he owns as an individual. This difference, however, must be defined by objectively workable tests, such as Congress supplied in § 355." Neither the Second Circuit nor the taxpayers have suggested any other way of identifying a true fission.

[6]Sec. 355. Distribution of stock and securities of a controlled corporation.

(a) Effect on distributees.

(1) General rule.

If—

(A) a corporation (referred to in this section as the "distributing corporation")—

(i) distributes to a shareholder, with respect to its stock, or

(ii) distributes to a security holder, in exchange for its securities, solely stock or securities of a corporation (referred to in this section as "controlled corporation") which it controls immediately before the distribution,

(B) the transaction was not used principally as a device for the distribution of the earnings and profits of the distributing

[92] section are detailed and specific, and [illegible] with precision. It is no doubt true, as the [illegible] emphasized, that the general purpose [illegible]

corporation or the controlled corporation or [illegible] fact that subsequent to the distribution stock [illegible] or more of such corporations are sold or [illegible] some of the distributees (other than pursuant to [illegible] negotiated or agreed upon prior to such distribution [illegible] be construed to mean that the transaction was not [illegible] as such a device).

(C) the requirements of subsection (b) [illegible] business are satisfied, and

(D) as part of the distribution, the distributing [illegible] distributes—

(i) all of the stock and securities in the controlled [illegible] tion held by it immediately before the distribution, or

(ii) an amount of stock in the controlled corporation [illegible] stituting control within the meaning of section 368 (c), [illegible] established to the satisfaction of the Secretary or his delegate [illegible] that the retention by the distributing corporation of the [illegible] stock and securities in the controlled corporation is not in pursuance of a plan having as one of its principal purposes the avoidance of Federal income tax, then no gain or loss shall be recognized to (and no amount shall be includible in the income of) such shareholder or security holder on the receipt of such stock or securities.

(2) Non pro rata distributions, etc.

Paragraph (1) shall be applied without regard to the following:

(A) whether or not the distribution is pro rata with respect to all of the shareholders of the distributing corporation,

(B) whether or not the shareholder surrenders stock in the distributing corporation, and

(C) whether or not the distribution is in pursuance of a plan of reorganization (within the meaning of subsection (a) (1) (D)).

(3) Limitation.

Paragraph (1) shall not apply if—

(A) the principal amount of the securities in the controlled corporation which are received exceeds the principal amount of the securities which are surrendered in connection with such distribution, or

(B) securities in the controlled corporation are received and no securities are surrendered in connection with such distribution.

For purposes of this section (other than paragraph (3) (B) of this subsection) and so much of section 356 as relates to this section, stock of a controlled corporation acquired by a distributing corporation by reason of any transaction occurring within 5 years of the distribution of such stock shall be [illegible]

to distinguish corporate fission from the distribution of [93] earnings and profits. However, although a court may have reference to this purpose when there is a genuine

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gain or loss was recognized in whole or in part, shall not be treated as stock of such controlled corporation, but as other property.

(4) Cross reference.

For treatment of the distribution if any property is received which is not permitted to be received under this subsection (including an excess principal amount of securities received over securities surrendered), see section 356.

(b) Requirements as to active business.

(1) In general.

Subsection (a) shall apply only if either—

(A) the distributing corporation, and the controlled corporation (or, if stock of more than one controlled corporation is distributed, each of such corporations), is engaged immediately after the distribution in the active conduct of a trade or business, or

(B) immediately before the distribution, the distributing corporation had no assets other than stock or securities in the controlled corporations and each of the controlled corporations is engaged immediately after the distribution in the active conduct of a trade or business.

(2) Definition.

For purposes of paragraph (1), a corporation shall be treated as engaged in the active conduct of a trade or business if and only if—

(A) it is engaged in the active conduct of a trade or business, or substantially all of its assets consist of stock and securities of a corporation controlled by it (immediately after the distribution) which is so engaged,

(B) such trade or business has been actively conducted throughout the 5-year period ending on the date of the distribution,

(C) such trade or business was not acquired within the period described in subparagraph (B) in a transaction in which gain or loss was recognized in whole or in part, and

(D) control of a corporation which (at the times of acquisition of control) was conducting such trade or business—

(i) was not acquired directly (or through one or more corporations) by another corporation within the period described in subparagraph (B), or

(ii) was so acquired by another corporation within such period, but such control was so acquired only by reason of transactions in which gain or loss was not recognized in whole or in part, or only by reason of such transactions combined with acquisitions before the beginning of such period.

question as to the meaning of one of the requirements Congress has imposed, a court is not free to disregard requirements simply because it considers them redundant or unsuited to achieving the general purpose in a particular case. Congress has abundant power to provide that a corporation wishing to spin off a subsidiary **[94]** must, however bona fide its intentions, conform the details of a distribution to a particular set of rules.

The Commissioner contends that the 1961 distribution of Northwest stock failed to qualify under § 355 in several respects.[7] We need, however, reach only one. Section 355 (a) (1) (D) requires that, in order to qualify for nonrecognition of gain or loss to shareholders, the distribution must be such that

> "as part of the distribution, the distributing corporation distributes—
>
> "(i) all of the stock and securities in the controlled corporation held by it immediately before the distribution, or
>
> **[95]** "(ii) an amount of stock in the controlled corporation constituting control within the meaning of section 368 (c), and . . . ."

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[7]The Commissioner contends, first, that Pacific did not distribute "solely stock or securities" as required by § 355(a)(1)(A), because it distributed rights rather than stock. He contends, second, that Pacific did not distribute the Northwest stock "to a shareholder, with respect to its stock" as required by § 355(a)(1)(A)(i), because it did not distribute the stock to shareholders but sold it to holders of transferable rights, for cash consideration. He contends, third, that Northwest did not meet the quantity requirements of § 355(a)(1)(D) because it parted with only 57% of the stock in 1961.

Any one of these arguments, if established, would support the result the Commissioner seeks. The Court of Appeals for the Second Circuit perforce rejected all three. The Court of Appeals for the Ninth Circuit accepted all three. We reach only the last.

Section 368 (c) provides in relevant part that

> "the term 'control' means the ownership of stock possessing at least 80 percent of the total combined voting power of all classes of stock entitled to vote and at least 80 percent of the total number of shares of all other classes of stock of the corporation."[8]

On September 28, 1961, the day before the first rights distribution, Pacific owned all of the common stock of Northwest, the only class of securities that company had issued. The 1961 rights offering contemplated transferring, and succeeded in transferring, about 57% of the Northwest common to Pacific shareholders. It therefore could not be clearer that this 1961 distribution did not transfer "all" of the stock of Northwest held by Pacific prior to it, and did not transfer "control" as that term is defined in § 368 (c).

Nevertheless, taxpayers contend, and the Second Circuit agreed, that the requirements of subsection (a) (1) (D) were here met because Pacific distributed the remaining 43% of the Northwest stock in 1963. The court said that the purpose of the subsection "in no way requires [96] a single distribution."[9] The court apparently

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[8] In the Tax Court, the Commissioner did not argue that Pacific had failed to meet the requirement that it distribute at least 80% of the Northwest stock, but rested upon his other arguments against applying § 355. When the Tax Court rejected these arguments, the Commissioner raised the 80% question, as well as his other arguments in both Courts of Appeals. Both considered the point on the merits, dividing on it as on the others. Since the general issue of the applicability of § 355 has been in the case since its inception, taxpayers do not contend that the 80% question is not properly before this Court. Since the record leaves no disputed issue of fact with respect to this question, we find it proper to decide it here without reference to a trier of fact.

[9] 382 F. 2d 499, 507.

concluded that so long as it appears, at the time the issue arises, that the parent corporation has in fact distributed all of the stock of the subsidiary, the requirements of § (a) (1) (D) (i) have been satisfied.

We are forced to disagree. The Code requires that "the distribution" divest the controlling corporation of all of, or 80% control of, the controlled corporation. Clearly, if an initial transfer of less than a controlling interest in the controlled corporation is to be treated for tax purposes as a mere first step in the divestiture of control, it must at least be identifiable as such at the time it is made. Absent other specific directions from Congress, Code provisions must be interpreted so as to conform to the basic premise of annual tax accounting.[10] It would be wholly inconsistent with this premise to hold that the essential character of a transaction, and its tax impact, should remain not only undeterminable but unfixed for an indefinite and unlimited period in the future, awaiting events that might or might not happen. This requirement that the character of a transaction be determinable does not mean that the entire divestiture must necessarily occur within a single tax year. It does, however, mean that if one transaction is to be characterized as a "first step" there must be a binding commitment to take the later steps.[11]

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[10]See *Burnet v. Sanford & Brooks Co.*, 282 U. S. 359, 363-365.

[11]The Commissioner contends that a multistep divestiture presents special problems in preventing bailouts of earnings and profits. The Second Circuit, recognizing such potential problems, held that they can be dealt with under § (a) (1) (B), which provides that nonrecognition shall result only when it appears that "the transaction was not used principally as a device for the

[97] Here, it was little more than a fortuity that, by the time suit was brought alleging a deficiency in taxpayers' 1961 returns, Pacific had distributed the remainder of the stock. The plan for reorganization submitted to shareholders in 1961 promised that 56% of that stock would be distributed immediately. The plan went on,

> "It is expected that within about three years after acquiring the stock of the New Company, the Company by one or more offerings will offer for sale the balance of such stock, following the procedures described in the preceding paragraph. The proceeds from such sales will be used by the Company to repay advances then outstanding and for general corporate purposes including expenditures for extensions, additions and improvements to its telephone plant.
>
> "The prices at which the shares of the New Company will be offered pursuant to the offerings referred to . . . will be determined by the Board of Directors of the Company at the time of each offering."

It was further stated that such subsequent distributions would occur "[a]t a time or times related to its [Pacific's] need for new capital." Although there is other language in the plan that might be interpreted as preventing Pacific management from dealing with the North-

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distribution of the earnings and profits of the distributing corporation or the controlled corporation or both . . . ."
Congress may, of course, have chosen not to leave problems created by multistep divestitures to specific adjudication under this "device" subsection, but to require *both* a unitary divestiture *and* satisfaction of the "device" requirement. Whether § (a)(1)(D) would prohibit or limit a divestiture of control committed from the outset but spread over a series of steps is a problem we need not reach.

west stock in any way inconsistent with eventual sale to Pacific shareholders, there is obviously no promise to sell any particular amount of stock, at any particular time, at any particular price. If the 1961 distribution played a part in what later proved to be a total divestiture of the Northwest stock, it was not, in 1961, either [98] a total divestiture or a step in a plan of total divestiture.

Accordingly, we hold that the taxpayers, having exercised rights to purchase shares of Northwest from Pacific in 1961, must recognize ordinary income in that year in the amount of the difference between $16 per share and the fair market value of a share of Northwest common at the moment the rights were exercised.

The second question presented by the petition in No. 760, whether the $6.36 received by taxpayers Gordon upon the sale of four rights was taxable as ordinary income, as a capital gain, or not at all, does not require extended discussion in light of our view upon the first question. Since receipt and exercise of the rights would have produced ordinary income, receipt and sale of the rights, constituting merely an alternative route to realization, also produced income taxable at ordinary rates. *Helvering v. Horst*, 311 U. S. 112; *Gibson v. Commissioner*, 133 F. 2d 308 (C. A. 2d Cir.).

The judgment of the Court of Appeals for the Second Circuit is reversed. The judgment of the Court of Appeals for the Ninth Circuit is affirmed.

It is so ordered.

MR. JUSTICE MARSHALL took part in the consideration or decision of these cases.

Appendix E

United States Court of Appeals
Second Circuit

At a Stated Term of the United States Court of Appeals, in and for the Second Circuit, held at the United States Courthouse in the City of New York, on the sixteenth day of March, one thousand nine hundred and seventy.

Present: Hon. Sterry R. Waterman,
Hon. Robert P. Anderson,
Circuit Judges
Hon. John R. Bartels,
District Judge

Irving Gordon and Margaret Gordon,
Petitioners-Appellants,
vs.
Commissioner of Internal Revenue,
Respondent-Appellee.

Appeal from The Tax Court of the United States.

This cause came on to be heard on the transcript of record from The Tax Court of the United States , and was argued by counsel.

ON CONSIDERATION WHEREOF, it is now hereby ordered, adjudged, and decreed that the order of said The Tax Court of the United States be and it hereby is affirmed.

A. Daniel Fusaro,
Clerk.

Appendix F

33772

United States Court of Appeals
Second Circuit

Irving Gordon and Margaret Gordon,
Petitioners-Appellants,

vs.

Commissioner of Internal Revenue,
Respondent-Appellee.

A petition for a rehearing having been filed herein by counsel for the appellants,

Upon consideration thereof, it is Ordered that said petition be and it hereby is denied.

Sterry R. Waterman
Robert P. Anderson, U.S.C.J.J.

May 1, 1970.

33772

United States Court of Appeals
Second Circuit

Irving Gordon and Margaret Gordon,
Petitioners-Appellants,

vs.

Commissioner of Internal Revenue,
Respondent-Appellee.

A petition for a rehearing containing a suggestion that the action be reheard in banc having been filed herein by counsel for the appellants and no active circuit judge having requested that a vote be taken on said suggestion.

Upon consideration thereof, it is

Ordered that said petition be and it hereby is denied.

J. Edward Lumbard,
Chief Judge.

May 1, 1970.